TRANSCRIPT

FEDERAL OPEN MARKET COMMITTEE MEETING

February 4-5, 1980

Prefatory Note

This transcript has been produced from the original raw transcript in the FOMC Secretariat's files. The Secretariat has lightly edited the original to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcript was not fully edited for accuracy at the time it was produced because it was intended only as an aid to the Secretariat in preparing the record of the Committee's policy actions. The edited transcript has not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Staff Statements Appended to the Transcript

Mr. Truman, Associate Economist
Mr. Jeffrey Shafer, Div. of International Finance, Board of Governors
Mr. George Henry, Div. of International Finance, Board of Governors
Mr. Pardee, Manager for Foreign Operations
Mr. Sternlight, Manager for Domestic Operations
Mr. Kichline, Associate Economist
Mr. Zeisel, Associate Economist
Mr. Truman, Associate Economist
Mr. Axilrod, Economist

Meeting of Federal Open Market Committee

February 4-5, 1980

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., starting on Monday, February 4, 1980, at 4:50 p.m. and continuing on Tuesday, February 5, 1980, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Balles
Mr. Black
Mr. Coldwell
Mr. Kimbrel
Mr. Mayo
Mr. Partee
Mr. Rice
Mr. Schultz
Mrs. Teeters
Mr. Wallich

Messrs. Guffey, Morris, Roos, Timlen, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Baughman and Willes, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Altmann, Secretary
Mr. Bernard, Assistant Secretary
Mr. Petersen, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Mannion, Assistant General Counsel
Mr. Axilrod, Economist
Mr. Holmes, Adviser for Market Operations

Messrs. Brandt, R. Davis, Ettin, Henry, Keir, Keran, Kichline, Scheld, and Truman, Associate Economists

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
Mr. Pardee, Manager for Foreign Operations,
System Open Market Account

Mr. Coyne, Assistant to the Board of Governors
Messrs. Kalchbrenner and Prell, Associate Directors,
Division of Research and Statistics, Board of
Governors
Mr. Siegman, Associate Director, Division of
International Finance, Board of Governors
Mr. Beck, Senior Economist, Banking Section,
Division of Research and Statistics, Board of
Governors
Ms. Farar, Economist, Open Market Secretariat,
Board of Governors
Mrs. Deck, Staff Assistant, Open Market Secretariat,
Board of Governors

Mr. Smoot, First Vice President, Federal Reserve
Bank of Philadelphia

Messrs. Balbach, Corrigan, J. Davis, T. Davis, and
Eisenmenger, Senior Vice Presidents, Federal
Reserve Banks of St. Louis, New York, Cleveland,
Kansas City, and Boston, respectively

Messrs. Broaddus, Danforth, Mullineaux, and Sandberg,
Vice Presidents, Federal Reserve Banks of Richmond,
Minneapolis, Philadelphia, and New York, respectively

Transcript of Federal Open Market Committee Meeting of
February 4-5, 1980

February 4, 1980--Afternoon Session

CHAIRMAN VOLCKER. I will call the non-meeting to order. We are not in a meeting at this point anyway; we may be in a meeting later. I would just remind all of you that I sent out a memorandum on the idea of possibly changing the [FOMC] meeting dates. It probably would amount to having fewer meetings on the theory that with the current operating procedure, I sense--maybe nobody else senses--that a meeting after only four weeks doesn't give us much evidence on which to change anything. With lagged reserve accounting and with a lag in the numbers, we're hardly in the period that we were discussing before the next meeting comes along. So there may be some logic in doing it a bit differently. This is partly based on the idea, after looking it over--and I think we all agree--that we need a little longer perspective. It seems to me better to get the longer perspective by sticking to calendar quarters rather than just always looking three months ahead on some kind of moving average basis. If we take that as an assumption, logically we should meet somewhere around the beginning of a quarter and look at that quarter. We can review it sometime during the quarter and also look ahead to the next quarter. Then when we get to the end of the quarter, we will be looking ahead at the next quarter. There seems to be a certain logical progression in that method of looking at it as opposed to meeting more frequently when the basic decision was whether or not to change the federal funds rate. But I will return to the subject at the end of the meeting and then [we will decide]. There's nothing magic about any particular time to change.

MS. TEETERS. Well, there is some magic in it. I looked at your [proposed] schedule and I thought that we probably should meet at the very end of the quarter to plan for the next quarter. Then I realized that we have constraints on two [meeting dates]. One is because of the budget and the [President's] economic report [and] the Humphrey-Hawkins testimony; so we have to wait until January to do that one. Then we have a similar constraint in July when we have to wait for the midyear review of the budget before we can do very much. I finally came around to your schedule on two of the quarters anyway. So, we might as well change the whole schedule into a similar pattern.

CHAIRMAN VOLCKER. Well, I had nothing invested in any of the particular dates or when we would change, if we change. But I do have the feeling that every four weeks is a little frequent if we are operating in this particular mode. I wouldn't feel that way if we were operating more on money market oriented criteria.

MR. ROOS. Could [we meet] on the original dates in those months instead of moving--?

CHAIRMAN VOLCKER. Well, it's a little hard. But look at the dates carefully. As I say, I had nothing invested in the particular dates that were put on that proposal, particularly when we get near [the usual] dates, if there are problems in changing them. For instance, for that proposed April 1, which looks logical except for April Fool's day, March 25 is almost equally logical. And we could basically have the same pattern by meeting on March 18th, because I understand [that date is on] everybody's schedule now, although that would leave a longer lapse before the next meeting. But there's nothing sacrosanct about any of those particular dates.

MR. ROOS. Is there supposed to be a response?

CHAIRMAN VOLCKER. No, you can wait until later; it can wait until after the meeting tomorrow. I just wanted to remind you to have it in mind so that if you have any strong feelings they could be adequately verbalized tomorrow.

The first thing on our agenda today is lagged reserve accounting. Mr. Axilrod.

MR. AXILROD. Mr. Chairman, lagged reserve accounting, as the Presidents and Board Members know, has been a subject of considerable contention in the System since it was adopted in 1968.

CHAIRMAN VOLCKER. We're going to get an issue pretty soon for which we just can't pull out the old memoranda.

MR. AXILROD. That's what I was getting to. There has been considerable contention since 1968 when it was adopted. And I must say from an internal perspective there was contention between 1966 and 1968, when it was being studied for adoption under a rather different institutional environment and different operating procedures than we now have. Various staff groups have studied this since 1973. I am afraid you are not quite getting independent results since I think I was Chairman of three of those groups. And they all three unanimously concluded that there is very little to be said for lagged reserve accounting from a monetary policy point of view if the Committee is operating on a reserves target. One can't make a case that it is the least bit of help and one can make a case that it is harmful. There have been divergences among the staff even in that context of it not being helpful. The question is: How harmful in fact is it? Some would contend more strongly than others that it's harmful over the longer run. Others would contend that it doesn't matter over the longer run: That with or without lagged reserve accounting we can perk along on a reserve target and manage to hit our objectives. I think that's a legitimate source of dispute because the long run is compounded of a number of short runs. And in a very simple-minded sense in any 1-week period there is no defined relationship between the multiplier on deposits and reserves in that week. That is, reserves this week can bear any relationship to deposits because all one has to do is worry about two weeks from now. So we rely almost entirely, therefore, on banks' responses to interest rates to control deposits. When you cut through it all, fundamentally that is no different from relying on a fluctuating federal funds rate target. So, I personally would tend to take the view that lagged reserve accounting can make it virtually impossible to hit our targets in the short run and probably is of some importance in making it difficult to hit our targets in the long run. Thus, I think it is really quite inconsistent with the present operating procedures. Now, I don't mean to say that there aren't other things that are equally difficult. The discount window is a problem and our own graduated reserve requirement structure is a problem. But in the latter regard, some of Mr. Lindsey's research would suggest that lagged reserve accounting accounts for bigger divergences in the multiplier from predictions than does the graduated reserve requirement structure.

CHAIRMAN VOLCKER. From Mr. Who's research?

MR. AXILROD. Mr. Lindsey, on my right. So I would say that while doing away with lagged reserve requirements is not going to solve all our problems in hitting the aggregates, it at least looks like a step in the right direction. In view of this cogent staff analysis, one might be curious as to the reason no action has been taken to date. I assume there have been two reasons. One was that with the federal funds rate operating target, which has been the principal System operating target for years, or even with a net borrowed reserves operating target, lagged reserve requirements are essentially an irrelevancy, like almost any reserve requirement is an irrelevancy. With a funds rate target, the Committee is simply trying to aim at that interest rate which will cause all the adjustments by banks and the public, whether or not there are reserve requirements, that will bring about the proper money supply. So in that sense it's irrelevant. The other issue was membership. The lagged reserve requirement is viewed as a benefit of membership. To test that view we did run a survey during one of these staff analyses and, except for those at the St. Louis Federal Reserve Bank, all of the directors of Reserve Banks who represented member banks said lagged reserve accounting was desirable. In St. Louis, the directors said it was undesirable.

MR. ROOS. When was that?

MR. AXILROD. That was in 1976.

MR. ROOS. That was before the good days!

MR. SCHULTZ. That sort of follows the pattern for most everything, doesn't it?

MR. AXILROD. The staff has no other way of assessing lagged reserve requirements as a membership benefit. One's instinct would be that it is minor relative to the real burden, which is the reserve requirement itself. In sum, Mr. Chairman, the staff does believe that it is probably appropriate now to move toward contemporaneous reserve accounting if the Committee is going to continue with a reserve targeting procedure. In that context, we did offer three alternatives in the memorandum. One is moving from a two-week lag to a one-week lag, which would presumably speed up the response of the banking system a bit. The second is making reserve requirements contemporaneous for Reserve City banks and leaving a lag for the other 5,000 banks. And the third is an essentially contemporaneous scheme for all banks. Without going through all the reasons that are detailed in the memo, Mr. Chairman, we did conclude that we see very little advantage to any move now except the move to contemporaneous accounting for all banks. That is, if the Board did not feel disposed to move toward contemporaneous accounting now, for whatever reasons, the staff would not suggest taking either of the other two alternatives. We believe that their advantages do not outweigh the disadvantages that might be entailed in terms of messed-up reporting, failure to quell the public debate, and certain problems of the multiplier that the mix system brings about. Those are all the comments I have, unless Mr. Lindsey would wish to add something.

CHAIRMAN VOLCKER. Well, you have not left a lot of doubt as to where you stand, Mr. Axilrod. Is there any dissenting opinion among the staff on the importance of this matter?

MR. LINDSEY. I might say that, if anything, my views are more extreme than Steve's.

CHAIRMAN VOLCKER. In the articles and academic papers and so forth that have been written on this subject, do they bring anything to light or make any argument that you have not made?

MR. LINDSEY. No, in preparing these memoranda for the Board, we thoroughly reviewed the literature starting from the early '70s on. My own view, which isn't particularly humble, is that the quality of the analysis presented here is much superior to the academic work.

CHAIRMAN VOLCKER. We would expect that! Well, it's just that the conclusion comes through a little more strongly than I read it in that memorandum itself. I had a feeling that you saw some disadvantages in the degree of certainty with which the Desk was operating. Maybe Mr. Sternlight would like to comment.

MR. STERNLIGHT. Yes, I'd like to add a word or two. I feel much less convinced than Mr. Axilrod that there would be significant benefits from a switch to contemporaneous accounting. I can see the theoretical case that he makes. I'd be among those who feel that in the longer run even that theoretical case makes very little, if any, difference. I can see some impediments to the Desk's operations under a contemporaneous system in that we don't know required reserves in the week we're operating in. Perhaps more significant than that, when some deviation in required reserves stems from a factor other than the behavior of the monetary aggregates--for example, a bulge in interbank deposits or something of that nature that essentially we would want to accommodate rather than resist as part of our reserve targeting--I think contemporaneous accounting could send us off in a perverse direction. So, I came out feeling that there is not all that much advantage to it. And having the minus on the membership side--I don't know how strongly to evaluate it, but I am told that it still does have some significance--just made me pretty dubious about the desirability of a change.

CHAIRMAN VOLCKER. Mr. Holmes, you were there before and after. Do you have any comments?

MR. HOLMES. Yes, Mr. Chairman. I can recall back in the great debate over whether we should have lagged reserve accounting, all sorts of claims were made that it was going to help the Desk tremendously and that the Wednesday [settlement date] would be a stable day in the funds market. We at the Desk never believed that. But, if it does make a difference for bank relations and on that ground alone it is useful to the banks, then we see no harm in the lagged reserve accounting. I feel very much as Peter does that it doesn't make all that much difference. It seems to me that the System has introduced enough other changes recently in statistics and in procedures that I see no urgent need, certainly, to go ahead with a move back to contemporaneous reserve accounting. Along with Peter, I doubt if it really makes that much difference.

CHAIRMAN VOLCKER. Well, we're not going to make a decision this afternoon, but anybody who would like to comment on this subject should comment.

MR. MORRIS. Mr. Chairman, I have long felt that if we're going to have a reserve operating base, sooner or later we are going to have to move to contemporaneous reserves. As one example, let's say that later on this year we get into a period where the money supply is not growing or is contracting. That would mean that in order to hit our target of total reserves, the Desk would have to push in very large amounts of excess reserves at the expense of a pretty sharp reduction in the funds rate. That might look a little funny if we're willing to do it, but it is one of the consequences stemming from lagged reserves. It is very awkward to control reserves with a lagged system. On the other hand, this is a very awkward time for us to make a change. As far as I am concerned, it's only a matter of timing--of when we do it. I don't think this is an optimum time, first because of the membership bill. I wouldn't want to throw anything on the fire that could in any way interfere with that bill. I'd want to hold off until it has been decided one way or the other. Second, all of our computer systems people in the whole Federal Reserve System are [working] flat out. We have the system automation program and we have the work going forward in connection with the pricing of Federal Reserve services. At least in the Boston Bank, we don't have any capacity to do the work on [a shift from lagged reserves]. And I think that is probably true around the System.

CHAIRMAN VOLCKER. How big a job is this for us internally as opposed to for a bank?

MR. TIMLEN. Depending on the alternative--the memo had three alternatives--some of our people said four to six months for programming.

CHAIRMAN VOLCKER. I am assuming going all the way to what is called contemporaneous reserves, which isn't quite contemporaneous; it's a one-day lag.

MR. MORRIS. I was told it would take us 90 days to implement it.

CHAIRMAN VOLCKER. Boy!

MR. BALLES. I'd strongly support what Frank has said. On the substance of the argument, I certainly join Steve; that's exactly where I come out. Like Frank, I would also stress that it would be very risky in my opinion even to raise this outside the Fed until we get a membership bill passed because there will be some adverse member bank relations in a transition. Secondly, I'd stress that both the banks and the Reserve Banks need a long lead time on this, longer than Steve thinks based on the impression I have from the staff memo. I would think six months would be an absolute minimum. When you think of banks in the West with statewide systems and 1,000 branches and so forth, it gets to be a very, very complicated system of reporting.

CHAIRMAN VOLCKER. You say it will take a long time because they will--

MR. BALLES. Well, both for the banks and for us for the reason that Frank said. Our data processing people within the Reserve Banks have been knocked flat by the tremendous number of changes in the current reporting series, by the cranking up of IBA, and by the marginal reserve requirements. We have the possibility of a membership bill on the horizon, which will bring us a lot more institutions to deal with. On top of that, all at the same time, if we try to plug in a very detailed, cumbersome, time consuming, expensive reprogramming effort and try to do it too quickly, I think we'll rue the day we did it. I'll tell you this: (1) I would hope that a decision would be made to move to contemporaneous reserve requirements; (2) I wouldn't even raise the issue unless we get a membership bill; and (3) then at that point, I'd make sure that plenty of study is given to lead time needs of both the banks and the Reserve Banks.

CHAIRMAN VOLCKER. I appreciate your caution about raising [this issue], but I did this morning.

MR. BALLES. Oh, you did? Now he tells me!

CHAIRMAN VOLCKER. I think your caution is well taken and I did it with some hesitancy. Mr. Mayo.

MR. MAYO. Well, most of my speech has already been given. But I would say of the three alternatives Steve presented, I certainly would agree with the staff, or the reserve requirements policy group, that a return to contemporaneous reserve accounting would be the preferred solution. I think it is better than lagged reserves. But I too feel, though I probably can't say it as eloquently as John just did, that it very definitely ties into the membership bill, and I would postpone it if only for that reason. I also feel, even though I am known around this table as a pragmatist or eclectic or something--no comment Mr. Roos--that there are two other ways that have not been thoroughly presented and discussed by the Axilrod Committee but should be. They have been subjected to a lot of good academic thought. Maybe they are cockeyed, but I can't see the holes in them myself yet, and I think they're worthy of discussion. One of them is Bill Poole's paper, Frank, on what amounts to a 100 percent marginal reserve requirement on the most recent changes since the last determination. The other is the idea of some sort of reverse lag where, as we all learned in our elementary money and banking text books, the Federal Reserve or the Central Bank sets the reserves. That isn't as silly as it may sound. We are not saying to a bank that it can't accept any more deposits because its reserves have already been set. That can be handled by the way it works through the accounting system. But it seems to me that both of those ideas have enough merit that they at least ought to be kicked around a little more by the SRAC and by Steve's group. So, while I agree that the major reason for delaying the implementation of this relates to the membership issue and the timing, I would suggest that we have a little more work to do in terms of analyzing these two ideas, just as examples. And if we want to blow holes in them, let's do it. But some of us, at least, are intrigued by these two ideas and the possibility that, if they work, they will bring us closer, though obviously not completely, to a chain drive rather than a belt drive, if I may use that [analogy].

CHAIRMAN VOLCKER. Have you looked at those, Mr. Axilrod?

MR. AXILROD. We have in the past looked at those and several other gimmicks that have been advanced.

MR. SCHULTZ. And he will now deliver an unbiased opinion!

MR. AXILROD. We'll be glad to consider them further.

MR. MAYO. There are good gimmicks and bad gimmicks. We deal only in good gimmicks.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, like Bob, my speech has been pretty well given. I'll start with a conclusion: I think it would be a mistake to make a change right now. There are several reasons. In addition to the ones that have been given, I think the magnitude of the problem has not been demonstrated to be great enough to justify the cost of a change at this time. We knew when we made the change years ago to lagged reserve accounting that it would have the effect it is having. But at that point we judged that the membership benefits overrode the negative effects it would have on the linkage between the policy target and achieving the target. It seems to me that the balance today is even stronger in the direction of membership than it was at the time we made the change. And my recollection is that the views we received from the Manager of the System Account then were the same as have been expressed today. The Desk did not see it as presenting an insurmountable operating problem. As to the suggestion that it's irrelevant if we're operating with a federal funds target, I find that persuasive. But it does seem to me that it's inappropriate to throw into the same box the net borrowed reserve target. That seems to me a different animal than the federal funds target. And the suggestion that we have to achieve the monetary aggregate target through interest rate effects is a part of any operating procedure. The people who borrow from banks and the bank officials who are handling banks' investment decisions are operating in response to interest rates. And it's through the interface of the banks and their customers that the asset side of their balance sheet is affected, and then the liability side seems to me to flow from that. So we cannot escape working through the interest rates in the market to achieve influence on the monetary aggregates. I think that's true whether we try to work through some reserve aggregate or a federal funds target or a net borrowed reserve target. It comes down to our ability, whatever the target, [to determine] the linkage between [our objectives] and the aggregate we attempt to affect. But in the final analysis [the key is] our willingness to let our efforts influence interest rates in the market.

Along with Bob's reference to a couple of items and gimmicks in the literature, I was expecting to see at least some passing reference--to use the vernacular on the table--to a "gimmick" that was kicked around fairly extensively a number of years ago: namely, grouping banks into about five groups and having their reserve settlement dates come up on a different day of the week.

MR. AXILROD. We have studies of that also, President Baughman. We will be glad to--

MR. BAUGHMAN. Well, I don't know whether [those in] the profession--

MR. MAYO. These are professional gimmicks!

MR. BAUGHMAN. On the willingness to let that [academic] feud quiet down: Was it a matter of your persuading them or simply that they felt we turned off our hearing aids?

MR. AXILROD. As far as Professor Friedman is concerned, I think it was the latter. He was the chief proponent of it.

MR. BAUGHMAN. It seems to me that we should anticipate that that will likely surface again. So, my view, Mr. Chairman, is that we should not change at the present time. I agree with the conclusion that our present mode of operation would work a little better if we were on a concurrent basis. But I think the cost of going there would be excessive now.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Just to set the record straight, I have a change of position since the advent of the age of enlightenment in St. Louis. We're strongly in support of contemporaneous reserve accounting. I would subscribe to John Balles' concern about moving before the operational changes have been considered and made and [so forth]. In talking to our bank relations people, I got the impression that as many banks dislike this lagged reserve arrangement as favor it. Anyway, let the record show that whatever happened in 1976 does not reflect our present position. We support it.

SPEAKER(?). Yes, in June of 1976.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, in deciding whether lagged reserves are good or bad for policy, I think we have to decide whether the likely errors in hitting the money supply stem from a lack of responsiveness to changes in the volume of reserves or whether they stem from unexpected changes in the appetite of the market for money of the type that Frank Morris assumed. If it's the first, then one can make a case that we get a little quicker response under lagged reserve requirements than under the other in the sense that if we inject a given volume of reserves, required reserves don't rise immediately, so the banks feel a little easier and they kick this off a little faster. In the case of unexpected deviations stemming from a shift in the demand for money, then we do have an automatic braking that comes about under contemporaneous reserve requirements that tends to stop this unexpected change in the demand for money. I think it's this latter type that's really the most troublesome for us under our present mode of operation. So that does give a slight edge to contemporaneous accounting under the present procedures. But I don't think we ought to overemphasize that. I come out very close to where Alan Holmes and Peter Sternlight did. At most, I would think the delay would be two weeks. And if you accept any of the points that

Irving Auerbach was raising in his debate with Bill Poole in the American Banker, then you may conclude that it may take longer than most people assume for these multiple contractions or expansions in bank credit to take place. In the kind of environment in which we are trying to bring about a steady rate of expansion in money, and given all these other slippages in the monetary multiplier, it's hard for me to see that it makes a great deal of difference under present procedures. But I do think that it is good for us, if we can, to quiet this criticism that has been stemming from the monetarists. I have two reasons: (1) It would divert their efforts toward trying to help us achieve a monetary target and they would stop assuming that it's as easy to hit as most of them have assumed; and (2) it would remove any excuse that we have for not hitting the targets. And both of those [results] would be rather salutary, I think.

As far as the other side of the coin is concerned, bank relations, a lot of the academic commentators assume that it's easier for a bank to adjust under contemporaneous reserve requirements because it does not involve as large a change in excess reserves. But they are not talking to the bankers I've talked to. I think most of the Reserve Banks now provide each of their banks with a daily statement on reserves, which shows their required reserves as determined from deposits two weeks earlier. They subtract from that any vault cash they held two weeks earlier, either add to that or subtract from it the amount of carryover from the previous week, and then show how much the banks must hold in their reserve balances for the remainder of the reserve period. In fact, we even show that on a daily average basis. So far as the small banker is concerned, all he has to worry about is looking at that statement that comes every day, early in the day--it never misses its schedule except when the carrier doesn't run, which is very seldom--and he knows exactly the reserves he has to hold on a daily average basis for the balance of that reserve period. And if he misses it a little, he has the 2 percent carryover. Most of them, if they watch it very closely, can get pretty darn close to zero excess reserves. But I wouldn't favor the adoption of alternative one--moving to a one-week lag--which I think is the best of those Steve outlined, for the reason that John Balles and Frank Morris and many of the rest of you have stated. It would be a major problem [of implementation]. But as we move ahead, we might think about how we could go to contemporaneous reserve accounting and yet solve this bank relations problem. The problem doesn't stem entirely from not having all the banks as members. I don't think we'd want to burden the banks unduly even if they were all [members].

So, what appeals to me most would be a month-long period of contemporaneous reserve accounting. I think that would have practically all of the advantages of the [weekly contemporaneous accounting period]. It would involve less rate volatility because banks would have more opportunity to engage in interest arbitrage within the reserve period. It would also give more time for this adjustment to the changes in the demand for money--that multiple contraction or expansion that some of the commentators seem to think occurs almost instantaneously. It would reduce the work of the Federal Reserve and the work of the commercial banks a great deal if we didn't have to put this out on a weekly basis. It would reduce the emphasis on the weekly figures that now cause us so much problems. And if we eliminated the carryover in the process--and I think we probably could get away with eliminating that if we went to a month-long period--it would eliminate a form of slippage. But there are some disadvantages to a month-long period without the carryover in terms of unexpected reserve movements toward the end of the period. And this would not be simply the last day in the case of many banks that don't know their required reserves until five or six days later. But if we did have an unexpected movement toward the end of the period, it would have an effect on only 1/28th to 1/31st of the whole period because of the month-long period as compared with an effect of 1/7th as we now have with a seven-day period. We also could not provide as much help to the banks through giving them statements of their required reserves, and that removes one of the inducements for them to report more promptly to us. Certainly that is important to us. Finally, with a long period of time, in a sense one could argue that the banks wouldn't have to come to grips with a change in reserve availability quite as promptly, and we might have some slippage there. But on balance, if we combined these two, that might conceivably be the best of the two worlds. But I would urge that we not move to that at this time for reasons others have already stressed.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, those were very thoughtful observations by Bob Black. I just would like to make two points on those before I briefly say what I meant to. I am not sure that we'll satisfy the monetarists by this change. I think their reasoning is that they want to minimize Desk operations. They believe that with contemporaneous accounting all the adjustment can take place through a change in deposits and none of the reserve needs have to be met by Desk operations. You pointed out that these adjustments of levels of deposits don't take place instantaneously. We need a very large change for each dollar of reserves, something like a $10 change in demand deposits and a $20 change in time deposits. These changes are really so large that they can't take place quickly; any reserve deficiency or surplus must still be met very predominantly from Desk operations. My other reaction is that the one-month procedure sounds like an ingenious possibility and well worth studying, but one can see the danger of slippage if we expanded this [time period]. Suppose we made it not one month but one year. One can see that that wouldn't be workable. So somewhere between a day and a year there is an optimum in terms of less disturbance but also less loss of effectiveness.

As far as moving to a contemporaneous basis right away is concerned, I think the gain we have in terms of the monetarists' analysis wouldn't be very great. The staff memorandum convinces me that the gain in terms of speed might be very considerable. The effects of any reserve shortage begin two weeks earlier unless we want to assume that somehow a reserve shortage or surplus casts its shadow ahead and the banks move into very short-term assets as soon as they see their deposits moving in one direction or another. But that isn't very likely because all they see is their own deposits moving; they don't see the aggregate moving necessarily. So, there does seem to be a significant advantage in terms of speed of adjustment and I think that is important because even though we say that it really doesn't matter over a quarter or so whether we deviate from our target, it is always very hard to get back on track. It doesn't matter if we deviate if we indeed get back on track. Nothing happens to the real sector. But getting back on track may be very painful because the forces that pushed us off may still be operative.

I have one question on something that I'd like to understand better. I have the impression that under the present procedure, the funds rate still serves as a guide to reserve needs. Peter seemed to say that if we move to contemporaneous, we would lose that. At present, a movement in the funds rate is an unambiguous indication that reserves are either too large or too small and it is clear that the Desk must take action unless it wants to have the reserve imbalance met by borrowing or repayment. If we have contemporaneous, then a move in the funds rate may mean indeed that market factors have produced a deficiency or excess of reserves. But it also may mean that the aggregates are moving in a particular direction, creating a reserve surplus or deficiency. If the latter is the case, we may not want to counteract that; we may want to let the change in the funds rate do its job. Say a decline in deposits leads to a decline in the funds rate. We would want the decline in the funds rate to help push deposits back up. So there seems to be a possibility of using the funds rate as a guide to operations under lagged [accounting] and less of a possibility to do that under contemporaneous. Since I am troubled, frankly, by the use of the funds rate as a guide to operations because it exposes us to the appearance of still being on a funds rate target, I wonder whether this wouldn't protect us against that suspicion that we're trying to control the funds rate rather than nonborrowed reserves and the aggregates. And I wonder whether the Desk wouldn't be able to judge what it needs to do--determine the need to add reserves or the absence of a need--without this indication coming from the funds rate.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. Well, I have the feeling that the honeymoon of our experiment is about over. Consequently, I get a little more itchy to fiddle with the machinery rather than to let it stand. I am convinced that the acceptance of the Federal Reserve making this [procedure] work is going to be more important than for membership and a whole host of issues. I would not back off because of the effect it may have on the membership legislation at this time. This is more important than the membership issue. I am convinced that while there are programming problems involved, we can get it done faster than we assume if we change our priorities a bit. I would give up on some of the other things we are doing, I think, and put this in place. I am not sure how much time [it would take] but the biggest problem is getting the Banks to rearrange their priorities in order to mesh with it. I would pick up on some of the other comments about the importance of saying that this [procedure] works. I am concerned that the slippages are going to show up much more. There is a lack of confidence in the market now about what we are doing and either [we need to do] that or look at the discount rate again, or perhaps both, very promptly or I think we are going to be in trouble.

I would like to raise one question. With [the development] of the managed liabilities and RPs and other things, are we seeing a change in the adjustment process now that will [become more pronounced] if we start to tighten? Are we seeing that [adjustment not] formally showing up in the deposit base but in some of these items? I get lost in all the accounting as to how that flushes out.

MR. AXILROD. We have often expected that when the System tightens, there will be an increase in managed liabilities that holds down demand deposits. For example, there would be an increase in issuance of CDs and RPs and all that. That didn't turn out to be true in the fourth quarter when there seemed to be a sharp reduction in bank credit demands. But for unchanged credit demands, so to speak, I would expect that to be an element in the adjustment process. It would be an aspect of the tightening--issuing [such] things and putting upward pressure on interest rates in so doing.

CHAIRMAN VOLCKER. Why do you think we are running out of honeymoon time or however you expressed it, Willis?

MR. WINN. Paul, I hear more doubts being raised in more areas than I ever thought possible. Their suspicion is that we are [not] on a money target [unintelligible] very much a funds target.

CHAIRMAN VOLCKER. We don't see it in the money supply figures.

MR. WINN. Well, we are confusing it by all these different money supply figures we are surfacing.

MR. PARTEE. We haven't done that yet.

CHAIRMAN VOLCKER. And they don't know--

MR. WINN. People are looking, Paul, at the reserve base until we get--

CHAIRMAN VOLCKER. I don't know how far the ingenuity of our staff goes, but we will get off bounds on one definition. We changed the definition in the seasonal adjustment factor--fixed it up perfectly, I would say.

MR. COLDWELL. If we shift from lagged reserve accounting to contemporaneous and confuse that issue--

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I speak somewhat tentatively on this subject which I have observed raging around here for many years. It is somewhat religious in character. By the way, St Louis, I think has always been on the side of the angels, Larry! They might have had a little falling off or--

MR. ROOS. Steve tells me we were the only people--

MR. PARTEE. I would say you were always in favor of contemporaneous accounting and I would say that Bob Black has always been against it because he saw the public relations cost or the bank relations cost. The latter was a major factor involved, I thought, in the Board's accepting the lagged way in the first place. I am impressed by Henry's argument. I do think the speed of adjustment is something that is going to plague us because I personally believe that sooner or later, but perhaps not right now, Willis, we're either going to get a big surge or we're going to get a big collapse in the aggregates and then we are not going to be able to do anything about it because of the lags with which the demand schedule can be affected. And two weeks is a meaningful amount of time in shortening that process, if indeed it does shorten the process. I don't know that it necessarily would because, after all, the Desk knows that the money supply has surged or has fallen out of bed before the reserves have to be put up to support the higher amount or the lower amount; and presumably if they don't follow a strictly mechanical formula, they can begin to make adjustments for it early on in their strategy. So even that can be overcome.

My biggest problem is that I would lean toward contemporaneous accounting except that I think the structure is much too complicated to use it. Reported deposits are extremely complicated; there is quite a variety of deposits with different kinds of reserves against them. And it seems to me all of that is much more difficult [to manage] on a contemporaneous basis; it would not be a disadvantage otherwise if we had a very simple structure. Now, it also happens that the membership bills all propose a very much simpler structure of reserves than we now have. And it seems to me that if [the structure were simpler], that would also tend in some sense, Bob, to do away with the bank relations problem because it is no longer an optional matter as to whether to follow the specified procedures. It seems to me that a very much simpler structure and the change in the whole reserve apparatus that would be associated with a new bill, which probably wouldn't take effect for six months or something like that, might be a time for introducing a change. But I would tie it to those kinds of developments; I wouldn't do it now.

By the way, I do believe the point made by Frank and others has some value: With our current way of processing the daily report of deposits and the programming that exists we probably don't have the capacity to make the change without risking a collapse of the structure. That has begun to bother me. So, I wouldn't do anything now; but the introduction of a new simplified system on different terms and conditions might be an occasion for going to it.

CHAIRMAN VOLCKER. Mr. Timlen.

MR. TIMLEN. Mr. Chairman, I have heard at least six economists at the Federal Reserve Bank of New York opine on the matter of reverting to contemporaneous reserves. Not one of them thinks there is any major advantage in such a change, so I will be disposed to follow that professional judgment in my Bank. I must say that John Balles has given most of my points in terms of the bank relations [effects of] such a change and I would like to stress the importance of that. It is lead time, not only at the Reserve Banks but at the commercial banks as well. I would say, too, that I don't think that First VPs are in a position to start changing their priorities in the computer support area. We have a number of very key projects going forward in that area to bring up our new FRCS 80 communications network. We are entering the area of resource sharing. And to change our priorities to accommodate something that is not held out as having a major advantage is to me very poor planning. I would also say that we have had so many changes in the area of reserves--and those changes involve a cost to our member banks--that this would just add to the difficulties of shaping things in an orderly way.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I also tread tentatively in an area like this. In general, I am persuaded by Mr. Axilrod's theoretical arguments that contemporaneous reserve accounting has advantages in the short run when applied to a reserve targeting approach to monetary control. Mostly though, I am impressed by what Mr. Sternlight and Mr. Holmes had to say, which is that it probably won't make a great deal of difference in how the Desk operates. I just have one question that I'd like to ask Mr. Axilrod, if I may. I assume you are familiar with Irving Auerbach's arguments in favor of lagged reserve accounting. I take it that this is essentially an argument that the effects of any shifts in money demand won't be very quickly felt in markets and that the argument is based on the actual behavior of commercial banks in their lending and in their portfolio management. I wonder what you would say in response to Mr. Auerbach.

MR. AXILROD. Well, Governor Rice, Irv has a much more complicated mind, I think, than I do. Also, the evidence with regard to bank response has been developed over a number of years when the System has been running a different kind of policy that is very accommodative to bank needs. If at today's interest rates the bank needed reserves, the System supplied it. So every banker worth his salt knew that he could rely on the federal funds market within plus or minus 1/4 percentage point to make his adjustments. In that kind of environment, adjustments do tend to be made quite slowly. That may be the best kind of environment; I am not questioning that. But I think that's the basis for the empirical evidence. Without lagged reserve accounting you introduce the possibility of controlling total reserves. Now, you may or may not want to control them literally, but you introduce that possibility whereas with lagged reserve accounting that's much more difficult to do. If you can control total reserves, offsetting borrowing as it occurs, then it follows that the banks are simply not going to be able to put out the deposits and that in consequence interest rates are going to move sharply up or sharply down as banks are forced to make those adjustments. If the Committee wants to move toward the kind of world where it is more certain of controlling total reserves in the short run, or indeed in the long run, then I think abandonment of lagged reserve accounting would make it more practicable to do so. Now, if bank adjustments take a long time, then it might require a lot more interest rate variation in the short run to overcome that kind of inertia. However, I would feel reasonably confident that after some transition period the process of bank adjustments would be much shorter. Of course, in that process banks would begin holding more excess reserves so we'd have that problem to worry about. I know this is somewhat general, but that's how I would respond to the kinds of comments that Irv makes.

CHAIRMAN VOLCKER. It depends in considerable part upon what we do with the discount window issue.

MR. AXILROD. Yes. I am sure, even if we leave the window open and don't close it, total reserves leaves you the possibility of chasing it. You may not ever catch it, but it leaves you the possibility of chasing it.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. I have only two comments, Mr. Chairman. First, I would agree with the Account Manager that this is likely to have [only] minor advantages. But secondly, I would caution the Committee that this is another interruption in the overall picture of [the policy] the Committee is trying to follow. If we add that on top of our redefined aggregates as well as possible daylight overdrafts and additions from the membership bill, we're likely to complicate the figures [further] and they are going to be difficult for people to follow, even our very good staff.

CHAIRMAN VOLCKER. I can't contemplate that possibility. President Willes.

MR. WILLES. Thank you, Mr. Chairman. I found Henry's comments and Chuck's comments particularly useful. So I would like to [be recorded as agreeing with] whatever you wrote down for them. I would add one thought, which goes back to the comment that Bob Mayo made. I am not much for gimmicks, either. But if there's a bank relations problem, as many think there is, it just might be possible that the kind of proposal Bill Poole made can be structured in such a way that we don't give much away but present it to the banks as though we are giving them something when we are taking away lagged reserves. His kind of penalty scheme, for example, in terms of the carryover would make it possible to say that we are going to take away lagged reserves but we are going to give banks some flexibility they don't have now. And yet if we structure that penalty in the right way, in fact, we're not going to give away much in terms of sloppiness in the reserve figures. Looked at in that way--unless, as Chuck says, we get the whole thing solved with the bill--it might be useful to consider a gimmick like that simply as a bank relations vehicle. It may be a means to get the advantages and not have the negative bank relations impact that some of us, at least, are concerned about.

CHAIRMAN VOLCKER. I guess everybody has talked who wants to talk. Is there anybody else who urgently wants to talk? Mr. Kimbrel. When I put the adverb in front of it, you're in trouble!

MR. KIMBREL. I have a personal bias toward contemporaneous reserves. And if we were operating so that we could accomplish it, I would certainly opt for that. But I suppose our real thrust [should be] Desk efficiency in discharging our directives, and those at the Desk don't seem to be too enthusiastic about contemporaneous reserves. I accept that against the environment of the costs of programming such a change at the Reserve Banks and commercial banks. And, Mr. Chairman, right at the moment <u>any</u> change in our relationships with our member banks, even this, is not exactly very well timed.

CHAIRMAN VOLCKER. Well, those cautions seem to be rather unanimously felt. I must say the other side of it is--I don't know how important it is substantively--that when we work with a two-week lag in the context of what we're trying to do now, one has a great sense of artificiality. We are working to affect a reserve figure that we always know we cannot affect because it always depends upon something that happened two weeks earlier. It leaves me at least with a very uncomfortable feeling over a period of time. But I think it has been useful to get all these considerations on the table. I don't know whether we have to look carefully at the reverse lag situation and so forth or not.

MR. AXILROD. Well, we can. It depends how promptly the Board would want to take this up. But Mr. Lindsey has already done considerable work in that area, so we would be in a position to develop something.

CHAIRMAN VOLCKER. You are in a position to talk pretty quickly about that. I don't know where we'll come out, but--

MR. PARTEE. Paul, if we are going to be doing additional studies on this, I have always been very taken by the notion of doing away with Saturday and Sunday, which is another gimmick.

CHAIRMAN VOLCKER. That's coming up anyway, isn't it?

SPEAKER(?). You mean for Federal Reserve purposes only?

MR. PARTEE. Yes, excuse me, for Federal Reserve purposes only, because of all the inefficiency of flows back and forth.

CHAIRMAN VOLCKER. Well, the relevance of that comment is that one thing leads to another. And there is this question of whether to make a whole bunch of changes at one time or to keep making changes, as I think we have been doing, that upset people.

MR. AXILROD. A memo on that very subject, on the effect of a move from 7 to 5 days, has been prepared for the Board. We didn't want to send it forward right at this time because of the confusion with the memo prepared for this meeting, but we do have a staff recommendation on that.

CHAIRMAN VOLCKER. At the very least, obviously, there are a lot of arguments to delay for a while. I think we ought to get all these things on the table; maybe we won't want to delay them all. We can look at the membership issue in a month or two and see where that stands, but we ought to have at least a preliminary feeling of how we would want to go, depending upon the resolution of that issue. Let's hope it gets resolved one way or the other. Well, I don't think there is anything more to add on this unless the Desk people want to say anything in conclusion. Well, it has been useful [to see] how uniform many of the views are about the theoretical desirability and the practical difficulties in this.

MR. AXILROD. Mr. Chairman, I would just like to add one footnote to this. From my perspective, it is not merely theoretical desirability and practical difficulty but, as you commented, the artificiality of playing with these numbers. That is driven home to me almost every week, so I feel some practical impact of that.

CHAIRMAN VOLCKER. Well, we're going to have a presentation on the international scene. I think a variety of questions have arisen on this which may or may not be of any immediate relevance to what we [do].

MESSRS. TRUMAN, SHAFER, and HENRY. [Statements--see Appendix.]

CHAIRMAN VOLCKER. Let's proceed to a formal meeting and hear from Mr. Pardee about the international [scene] in the last month now that we've heard about it for the next two years.

MR. PARDEE. Every time somebody mentions the international value of the dollar, I don't know where I am. I feel like the zoo keeper who is worrying about lions and tigers and bears and is told that the animal kingdom is improving or not improving during the course of the day. I am working in a different world than the one we've just come from, though I have great sympathy with many of the things that were said. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions for the zoo keeper?

MR. BAUGHMAN. I move slowly now so I didn't really capture what you said in that very last statement. If the Bundesbank sells dollars and takes in marks presumably, you say we may share in those marks. What are you telling us?

MR. PARDEE. We have a bit of a dilemma. It would be rather nice to see the dollar rise at this stage, after all the pressures that the dollar has been under for these many months. And on that basis, it's awkward for us to see the Bundesbank go into the exchange market and sell dollars and thereby keep the dollar from rising as it might otherwise. At the same time, we have $2.6 billion worth of swap debt remaining and I am going to have to ask for a second renewal on a good chunk of that swap debt. And the U.S. Treasury has a very substantial short position in that it used a lot of the resources of the earlier Carter notes in the intervention last fall. So, we have a rather great need for marks. We have to balance off our wish to see the dollar rise a little to reinstill a bit of confidence in the market in the dollar against this need for mark resources.

MR. BAUGHMAN. Are you telling us that the procedure has a possibility of lightening our mark debt?

CHAIRMAN VOLCKER. When the Germans sell dollars and buy marks, they give some of them to us sometimes.

MR. PARDEE. That's right.

MR. PARTEE. They give them to us?

CHAIRMAN VOLCKER. They sell them to us.

MR. PARTEE. For dollars? How do they get an advantage out of that?

CHAIRMAN VOLCKER. Because we're repaying the swap.

MR. BAUGHMAN. Are you projecting a reduction in our mark debt?

MR. PARDEE. I am if the dollar remains where it is [or] continues to rise. There is still a rather substantial calendar of mark-denominated issues coming into the international markets, which will be converted at the Bundesbank. And this rediversification--there's no term for it and the politics only goes one way--this flow of funds back into the dollar provides us with opportunities. The Bundesbank had one offer put to them this morning on which it decided it didn't like the exchange rate. We would see quite a bit of that as well: People coming back to the dollar, selling large chunks of marks on the exchange market, and either the Bundesbank or ourselves taking those [marks] off the market.

MR. BAUGHMAN. Our decision as to whether to use any marks we acquire for the purpose of repaying debt will hinge not on the fact that we've got some marks but rather on what is happening in the exchange rates?

MR. PARDEE. Well, there is a certain urgency as far as our repayment of debt is concerned. And whenever the dollar is strong enough to take it, we open doors and windows. We have not gone into the exchange market as an open buyer of marks. That's one point I was making in my [report]. But to the extent that someone comes along and offers marks to us, we will take them and use them to repay debt.

MS. TEETERS. Why is there a certain urgency of repayment? Are those bonds coming due?

MR. PARDEE. We've had swap drawings outstanding since last June and we're going into the second renewal on a number of these.

CHAIRMAN VOLCKER. You have a recommendation to make in that connection?

MR. PARDEE. I don't have the numbers, but between now and the end of February we have a rather substantial list of swap drawings, totalling about $1.8 billion, coming up for second renewal.

CHAIRMAN VOLCKER. We have to ratify the transactions since the last meeting. Do we have a motion to that effect? Without objection they are so ratified. And you are asking for permission to renew $1.8 billion of swap debt maturing between now and the next meeting?

MR. PARDEE. By the end of February.

CHAIRMAN VOLCKER. When are we going to meet next--March?

MR. PARDEE. Not until March 28th.

MR. PARTEE. The drawing has been outstanding for six months, Scott?

MR. PARDEE. Yes.

CHAIRMAN VOLCKER. This goes beyond any feasible next meeting date I am sure. Do I have a motion? I do and I have an enthusiastic second. Have we any objections? If not, are there any other questions or comments on this?

MR. COLDWELL. Your pressure for urgency of repayment is merely the annual date coming up?

MR. PARDEE. It's not merely the annual date; I think I have a responsibility to the Committee to keep these things short term.

CHAIRMAN VOLCKER. He always feels under pressure. I don't know--

MR. COLDWELL. I understand that, but I thought you were conveying a sense of real urgency and that maybe we ought to take further steps than what we're now taking.

MR. PARDEE. Oh, no, I am not trying to go in that direction, as far as the policy is concerned. But in terms of my own responsibilities I feel that I have an urgency to clear this up. Now, there is a tradeoff--we have to choose--because we're covering this debt at a rather substantial loss to the Federal Reserve. And if we waited three months or six months, the exchange value of the dollar might be such that we could repay at a profit. On the other hand, experience has shown that to be a 50-50 [probability]; we might be paying it off at a substantially greater loss. I would rather get it off the books while we have the opportunity and free up our resources for later problems.

MR. COLDWELL. I was just testing the degree of urgency you're putting on this.

CHAIRMAN VOLCKER. Only his normal pressure.

MR. WALLICH. Nothing as drastic as going into the market and buying some D-marks.

MR. COLDWELL. And nothing as drastic as the Bundesbank telling you that we have to get out [of debt].

MR. PARDEE. Well, we're having daily conversations with them on their pace of selling.

CHAIRMAN VOLCKER. I forgot to ask for approval of the minutes of the last meeting. Without objection, they are approved. How long is your presentation, Mr. Kichline?

MR. KICHLINE. Probably about 20 minutes.

MS. TEETERS. But then the questions will take it beyond that.

CHAIRMAN VOLCKER. We don't have time for questions. There is no ground swell for wanting to hear that presentation tonight. In that case, maybe we'll dispose of Mr. Sternlight. He's always very [brief].

MR. STERNLIGHT. I don't think I'll take that long, Mr. Chairman. Shall I go ahead?

CHAIRMAN VOLCKER. Yes.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Before I forget, maybe we can go ahead and ratify your transactions. Without objection they are ratified. I think we'll do no more than hear whatever comments or questions you have to Mr. Sternlight.

MR. WALLICH. Could you expand a little on what you perceive as market expectations about future inflation? I see that Treasury bill futures, for instance, have changed by a very substantial amount, something close to 100 basis points over a month or so.

MR. STERNLIGHT. I hadn't focused on a particular quantity, Governor Wallich. It's just that "expectations of inflation" seems to be the most commonly cited factor for this very marked rise in the longer end of the market, with the longer bonds up about 100 basis points over the past month. And there is the budget message; even though it perhaps more frankly acknowledged inflation than some past Administration messages, there is still the feeling that if the Administration is saying it's that bad, it's going to be even worse. I guess this is the kind of thing that greets one at times like this.

CHAIRMAN VOLCKER. You mentioned that some people thought the new money supply figures would look higher. Why should they have that idea?

MR. STERNLIGHT. I suppose just fear of the unknown, really. We're coming out with something new, and it's partly that. It's partly perhaps a misconception that since these new series are likely to include some elements that have been growing rapidly the aggregates will tend to show more rapid growth. That's the feeling. If there is some account taken of the checkable deposits and money market funds--

CHAIRMAN VOLCKER. The reason I asked is that they don't have any sense of this revised seasonal.

MR. STERNLIGHT. No, but they have expressed skepticism about the recent seasonal. Certainly I have heard the comment that the slow growth in the past few months may have partly reflected an inadequate seasonal adjustment for that period.

MR. BLACK. Peter along those same lines, all the new definitions in January would show greater growth rates than we had for those same measures in September to December whereas all the old ones show less in January. What is the market going to say to that? This is very closely related to what you were saying.

MR. STERNLIGHT. Well, I think they might feel that some of their skepticism was well placed.

MR. BLACK. That's what I am afraid of, really.

CHAIRMAN VOLCKER. We have a press conference scheduled for Thursday, I think, to attempt to explain these new figures, and that question is sure to arise. I don't look forward with a great sense of anticipation to trying to explain either the substantial actual complications or the fact that the numbers look higher.

MR. PARTEE. We do have the revised seasonal, Paul. That's an annual event to revise the seasonal.

CHAIRMAN VOLCKER. But it doesn't have to go higher.

MR. PARTEE. Well, it happens to have done what the market expected it to do. That is, it raised the seasonal factors for the winter quarters and dropped them for the summer.

CHAIRMAN VOLCKER. We have lots of problems. This M2 number is more like the old M3 number, but since it's called M2 and is higher than the [old] M2, we've got a problem. Any other questions or comments?

MR. BLACK. Stress the long run. Go back to the [previous] six months and it will look a little better as you explain it.

CHAIRMAN VOLCKER. We will adjourn until tomorrow at 9 a.m.

[Meeting recessed]

February 5, 1980--Morning Session

CHAIRMAN VOLCKER. We got through our agenda down to item 4 anyway, yesterday. I suggest that we begin with the staff report on the economic situation and then perhaps take a little more time, if we want to, on the discussion of the economic situation and implications for the longer-term ranges in the light of the fact that this is the meeting at which we have to set them for a year ahead. Mr. Altmann tells me he would appreciate, for purposes of writing the minutes anyway, a fuller discussion of your views than we have had at some recent meetings. But more important substantively is the fact that this is the annual meeting where we have to consider and rationalize what we do in terms of the longer-range outlook. In that connection, I don't know whether all of you noticed that the President exercised his prerogative to relocate, I guess is the right word, the Humphrey-Hawkins objectives. In the original Act they were 4 percent unemployment and a 3 percent rate of price increase in 1983, and he moved back the unemployment objective 2 or 3 years and the price objective--what, 5 years?

MR. PARTEE. I think it's 1986 [for the unemployment objective] and 1988 [for the price objective].

CHAIRMAN VOLCKER. Yes, it was 3 years and 5 years. It is the first time that particular prerogative has been exercised, and maybe it will make everyone feel more relaxed regarding how one reconciles what we do with the dictates of that Act. I mentioned last time that it might be useful--I will not insist upon this--to quantify your feelings about the outlook. I'd say the best way to do it in terms of the real GNP would be on a fourth quarter-to-fourth quarter basis. In terms of prices, the consumer price index is the easiest one to think about. And I suppose the unemployment rate would be the traditional one. If you want to give some sense of your figures, you can do it with any appropriate qualification that you think is desirable: That you feel reasonably confident about it or immensely uncertain about it or anything in between, because I think that is part of the flavor within which we must operate. [We need] to take account of the uncertainties in setting our own policy. Given where we're starting, I hope to have a great revolution and perhaps have the coffee break a little earlier, more toward the breakfast hour than toward lunch, after we finish the discussion of the economic outlook. With that, you may begin, Mr. Kichline.

MESSRS. KICHLINE, ZEISEL, and TRUMAN. [Statements--see Appendix.]

CHAIRMAN VOLCKER. I'm a little confused by this last chart. This shows a rising rate of inflation through most of the first half of 1981, or the first quarter anyway. I thought your projection earlier showed a declining rate of price increase over that period.

MR. KICHLINE. Well, this is the GNP implicit deflator; on a fixed weight basis it goes down. As you know, the GNP implicit deflator subtracts out the energy prices coming from abroad and, in fact, gives us a lower number than is being experienced domestically. So the implicit deflator at this time would be an understatement of the impact of inflation in this early 1980 period. The fixed weight deflator is around 10 percent.

MR. PARTEE. How do you reach those confidence ratios? I don't really understand the process by which you get a 70 percent confidence interval.

MR. KICHLINE. We use the errors from the quarterly model in the equations, which are determined from past history. We run a large number of simulations; in fact this is based upon 400 experiments with the model. And when looking at that, we determine it with a 70 percent confidence interval.

MR. PARTEE. How many were above?

MR. KICHLINE. How many of those were above and how many below? In effect, using this very large number of simulations, the model would say that 70 percent from the past fall within that bound.

MR. SCHULTZ. I'd like to comment--I'm probably the only simple-minded person on the Committee--that I found your presentation to be the best I've seen. It was presented in a form that I found very easy to understand and I liked it.

MR. KICHLINE. Thank you.

MR. COLDWELL. Could I ask a question, Mr. Chairman? The Chairman [of the Congressional Committee] has asked us to talk about possibilities regarding real GNP, the CPI, and unemployment. As I understand your presentation, your real GNP forecast for 1980 would be down 2.2 percent.

CHAIRMAN VOLCKER. Now, wait a minute. That's for the year as a whole, isn't it?

MR. KICHLINE. That's fourth quarter-to-fourth quarter.

MR. COLDWELL. Isn't that what you're asking?

CHAIRMAN VOLCKER. Yes it is.

MR. COLDWELL. And you have the unemployment rate at 7-3/4 percent at the end of the year.

MR. KICHLINE. That's right.

MR. COLDWELL. What's your CPI? That is what he asked.

MR. KICHLINE. Well, you'd want to add a line on that table for the staff forecast for 1980, QIV to QIV. The staff has a forecast of 11.4 percent for the increase in the CPI. And for 1981 the staff forecast for the CPI is 8.6 percent. Just for comparison--

CHAIRMAN VOLCKER. For the fourth quarter of 1980 you have what?

MR. KICHLINE. No, for the percentage change from the fourth quarter of 1979 to the fourth quarter of 1980 we have 11.4 percent.

CHAIRMAN VOLCKER. What is the rate of consumer price increase in the fourth quarter of 1980?

MR. KICHLINE. 9.2 percent.

MR. COLDWELL. But the change over the year is 11.4 percent?

MR. KICHLINE. Well, we have a forecast of around 15-1/2 percent in the first quarter of this year with a combination of energy [prices] and high mortgage rates driving it up. It drops to 11-3/4 percent [in the second quarter] and then to 9-1/4 percent in the second half of this year, which measured fourth quarter-to-fourth quarter gives you around 11-1/2 percent.

CHAIRMAN VOLCKER. I don't understand. What was it in the fourth quarter of last year?

MR. KICHLINE. 13.0 percent.

CHAIRMAN VOLCKER. And it's going to be 9.2 percent in the fourth quarter of 1980, according to this projection?

MR. KICHLINE. That's right.

SPEAKER(?). Give or take a percentage point.

CHAIRMAN VOLCKER. What is this change of 11 percent that you're talking about?

SPEAKER(?). Fourth quarter-to-fourth quarter.

MR. KICHLINE. You take the level of the index in the fourth quarter of 1979 and calculate the percentage change in the level to the fourth quarter 1980. Early in 1980 we have very rapid increases in the CPI and they slow later on.

MR. MAYO. Why don't you give us the quarterly figures. It may help us.

MR. SCHULTZ. And year-over-year is different from fourth quarter-to-fourth quarter.

MR. KICHLINE. Well, if you want to look at some of these numbers: The fourth quarter of 1979 is 13.0 percent; the first quarter of 1980 is 15.6; the second quarter is 11.7; the third quarter is 9.2; and the fourth quarter is 9.2. Measured fourth quarter-to-fourth quarter, that is an increase of 11.4 percent.

MR. SCHULTZ. What do you have year-over-year, for 1980 over 1979?

MR. KICHLINE. I think we have that on a different table. If not, someone may have a calculator and we can--. It's 12.8 percent.

CHAIRMAN VOLCKER. I just have to decide what figure I want here. I think I want the fourth quarter rate of change, your 9.2 percent figure.

MR. PARTEE. Yes, I think that's right. The rate of inflation as measured by the CPI is reduced by the end of the year to 9-1/4 percent. The Administration has more than that, doesn't it?

MR. KICHLINE. I have a December-to-December calculation for the Administration. They didn't calculate it quarterly; I have the details, [so I can] calculate it. It's roughly comparable. For fourth quarter-to-fourth quarter it's 10.4 percent in 1980, which compares to our 11.4 percent. And for 1981 we're both at the same level, 8.6 percent from the fourth quarter to the fourth quarter.

CHAIRMAN VOLCKER. The figures we are looking for, then, are the [counterparts] of your minus 2.2 percent--that's the fourth quarter-to-fourth quarter change in real GNP--the level of unemployment in the fourth quarter, and the rate of change in the consumer price index during the fourth quarter.

MR. PARTEE. You want the CPI in our [forecasts] rather than the implicit deflator?

MR. MAYO. It happens to be the same; it's 9.2 percent for the fixed weight price index, too.

MR. PARTEE. It does happen to be the same.

CHAIRMAN VOLCKER. Can you tell me what the consensus is of private forecasts at this point?

MR. KICHLINE. The consensus of price forecasts or what?

MR. SCHULTZ. For everything.

CHAIRMAN VOLCKER. Well, for these three items or some approximations thereof.

MR. KICHLINE. Well, I don't have a consensus. I can give you some numbers based on a couple of the econometric model forecasts. I might just say that a great deal of difficulty is associated with this sort of exercise in that both the monetary and fiscal assumptions differ. And in many cases one doesn't know what the energy price assumptions are. Most outside forecasters that I am aware of now include in their control projections some sort of tax cut as well as a considerably more expansive monetary policy if specified, or if not specified, implicitly so. Most of them have a recession, I would say, that is two or three quarters in length beginning now. They have maintenance of very high prices and a much sharper recovery in activity late this year or in 1981. The Wharton model is something like that, for example, and they do have a tax cut. And they assume M1 growth of 6-1/2 percent compared to our 5 percent. In comparison, the bill rates in that sort of forecast by the fourth quarter of this year are below 10 percent, compared to 11 percent in the Board staff's forecast. So, a good deal of the difference probably relates to alternative policy assumptions. DRI is the most confusing of all. It has an increase in nominal GNP from the fourth quarter of 1979 to mid-1981 that averages 10 percent at an annual rate and has the bill rate going down 3-1/2 percentage points. All of that is achieved with a 4-1/2 percent M1 growth, which is magic compared to anything in the postwar period.

MS. TEETERS. Do you have the interest rate assumptions in the Administration's forecast?

MR. KICHLINE. Yes, I do. Do you want a fourth-quarter level or--?

MS. TEETERS. Fourth-quarter level.

MR. KICHLINE. The level in the fourth quarter of 1980 is 9.6 percent on the 3-month bill rate; in the fourth quarter of 1981, it's 8.8 percent. The staff forecast has a bill rate of 11 percent in Q4 1980 and 11-1/2 percent in Q4 1981. There is no explicit money assumption that goes with the Administration's forecast.

MR. COLDWELL. But if you calculated it, what would it be? They must have some [implicit assumption]. Is it higher than yours?

MR. PARTEE. It would have to be higher.

MR. COLDWELL. It has to be higher than yours.

MR. AXILROD. We are very pleased that they have not put that in.

MR. MAYO. Me, too, Steve.

CHAIRMAN VOLCKER. They may be using a different equation.

MR. MORRIS. Let sleeping dogs lie, I guess.

MR. SCHULTZ. Eggert is very cheap. Why don't you go ahead and buy it so you can have it?

MR. KICHLINE. We do buy it; I don't look at it. Well, I can't say I don't look at it. It's a rundown of 30 or 35 forecasts. Unfortunately, they come out with different time periods and no listing of the policy assumptions, so it's very difficult to compare one to another. It's helpful if one just wants to scan what private forecasters are thinking, but we've had difficulty trying to relate our forecast to others unless we have the detail of the monetary policy [assumptions], for example. But we do receive that and do look at it.

CHAIRMAN VOLCKER. Let me add one more item on the list that I asked you to comment on and that is the fiscal policy [unintelligible]. Mr. Roos.

MR. ROOS. Jim, maybe you've answered this. I am a little lost. On the GNP implicit price deflator, where your projections show an increase into 1981, did you put any weight on monetary policy? In order words if, as we have announced, we are going to reduce gradually the rate of money growth, do you still anticipate this upward movement in the deflator, or was that not put in your--?

MR. KICHLINE. No, that plays a very important role. But we have inflation coming down in 1981; it's not going up.

MR. ROOS. But you show it going up [initially]; it's sort of a roller coaster.

MR. KICHLINE. Well, as I say, in part the deflator is a statistical artifact when import prices are rising very rapidly. I do believe that there's little that can be done to change the course of price developments within the next three or four months. In fact, already just about half of the first quarter is over, so in our view we're locked into a very adverse price performance in the first half of this year.

MR. ROOS. Do you see that prevailing through the second quarter of 1981? In other words, you don't see any relief even though we're doing what we are doing here in gradually reducing the rate of [monetary growth]?

MR. KICHLINE. As I say, part of that is attributable to the performance of import prices in influencing this calculation. It is our view that prices do improve. If you take a look at an alternative measure of prices, in the section that Jerry Zeisel was referring to--go back one section [in the handout] right before the yellow sheet--there is a chart that plots the gross domestic business product, which is a fixed weight price index. There some of the problems from shifting weights are at least taken out, and you can see that we do have a decline beginning in the second half of this year, stretching into and throughout 1981.

MR. ROOS. But if we hang in there, which we are determined to do, and keep firm control over and gradually reduce the growth rate of whatever Ms we are controlling, don't all these other things fall into line? Or do you still have to run 400 equations to see what--?

MR. KICHLINE. What falls into line? I only wanted to tell you that while we give you point forecasts, we're quite aware that there's a wide range of error associated with any forecast. We tried to look at past history to suggest how big that range is, and it's sizable. We have no difficulty with your point that monetary policy over time does have an influence on the economy and on prices. In fact, the answer is: Yes, we agree.

CHAIRMAN VOLCKER. Mr. Willes.

MR. WILLES. Thank you, Mr. Chairman. Like Governor Schultz, I found this a particularly interesting presentation, but I think for a slightly different reason.

MR. BLACK. You mean you're not simple-minded?

MR. WILLES. Without touching that line with a 10-foot pole, I want simply to refer to the very last chart! I think the staff has done us a great service in presenting that because with all the conversation about whether the increase in the CPI is going to be 9.2 percent or whatever, if you look at that band [depicting the range of error], that's an incredibly large band. We talk about the CPI in the fourth quarter and it could be plus or minus some very large numbers. While it's useful to go through these exercises to see where we come out, I think we really don't pay as much attention as we should to the enormous uncertainty that attaches to these forecasts. We've had some people doing some work at our place--and I don't understand the technical details so I won't take you through it--but let me just give you an example of the kinds of problems one runs into in making quantitative forecasts. If you think of watching a wagon on a TV screen or a movie screen, you'll notice that the wagon is going forward and it looks like the wheels are going backwards. The reason for that, of course, is that as the wheel goes forward in the first frame the spoke is up in the center and then it goes forward and it's the second frame before it gets all the way back up to the top again and so on around. So, even though the wheel is moving forward, when you take pictures, it looks as if it's moving backwards.

MR. PARTEE. It depends on the speed of the projector.

MR. WILLES. You're exactly right. It depends on the speed of the projector and the speed with which the wheel is moving. Now, let's suppose that decisions are made in continuous time and you take econometric snapshots on a monthly or quarterly basis. It could be a matter of pot luck that the speed of the decisionmaking framework and the speed of the projector are the same. If they're not, you can actually take a picture that gives you just the opposite view of what's going on. We happen to think that in many cases that's exactly what happens. We have all these nice pictures that are actually giving us pictures exactly the opposite, in terms of policy implications, of what is going on in the "real world" and how it's functioning. I simply say that to indicate that I think we need to be particularly [cautious] at this time, given not only the uncertainties in the world but the uncertainties about the tools that we're working with, about what we think we can even say in terms of the time path for the economy over the next eight quarters.

CHAIRMAN VOLCKER. You have expressed yourself eloquently on the wide band of uncertainty. Would you care to express a view on the central tendency as you see it? Or are you so uncertain that you have no view on this policy?

MR. WILLES. If you press me to the wall, I will. I don't think I can say anything with any credibility, but I'll give you numbers anyway. And if the numbers turn out to be--

CHAIRMAN VOLCKER. Well, I think it is not unimportant that you say there's a great degree of uncertainty and I would like to get that--

MR. WILLES. With that great big long caveat that I just gave you, the numbers that we have in terms of real GNP for 1980 are more positive than the staff's. We think on balance that there's going to be some very modest positive real growth during 1980 and we tie that in with what we see happening with fiscal policy and slightly stronger business investment. I don't quarrel at all with the staff's deflator number or their CPI number. If anything, though, given what I just said about defense spending and so on, those numbers might turn out to be low rather than high. I also don't quarrel with their unemployment numbers.

MR. PARTEE. Even though you have positive output growth, you would agree with that unemployment number?

MR. WILLES. Yes.

CHAIRMAN VOLCKER. Do you have any particular feeling about fiscal policy?

MR. WILLES. Yes, the deficit is understated.

MS. TEETERS. By the staff or--?

CHAIRMAN VOLCKER. That is, without a discretionary tax decrease it is understated.

MR. WILLES. But by how much, I--

CHAIRMAN VOLCKER. Do you wish to say whether you think a tax cut is a good idea or not?

MR. WILLES. I think a tax cut would be a disaster.

CHAIRMAN VOLCKER. Okay, that's a clear view! Mr. Timlen.

MR. TIMLEN. The one number I can read accurately from this whole list of numbers is our projection of unemployment in the fourth quarter of 1980, which is 7.3 percent. In New York we're probably giving more weight to defense spending than the Board staff is giving, not only in terms of defense spending by the Federal government but capital expenditures by the private sector in anticipation of government orders. In terms of real GNP, then, our picture for the year, quarter by quarter, differs slightly in the timing and the depth of the possible recession. Our four quarters run a positive 1 percent for the first quarter, a positive 0.5 percent in the second quarter, then two negative numbers in the third and fourth quarters of minus 1 and minus 2 percent. On a full year average basis that comes out to [minus] 0.6 percent. Our deflator quarter by quarter ranges between 8.5 and 8.9 percent, so for the year we have 8.5 to 9 percent inflation [as measured] by the deflator. Our CPI is somewhere around 10-1/2 to 11 percent. One thing that I would throw out that you have not asked for is that our people in New York think the saving rate will continue to be quite low for the entire year of 1980; to wit, they have it averaging out at 2.9 percent.

CHAIRMAN VOLCKER. What are you assuming on the saving rate?

MR. KICHLINE. It drifts up and for the year 1980 averages 4-1/2 percent.

MR. TIMLEN. Yes, there's a big difference between the Board staff forecast and ours on the saving rate. On the federal fiscal situation, for fiscal 1980 we are looking at a deficit close to $45 billion; I'd say $40 to $45 billion. And for fiscal 1981, depending upon a tax cut, we have $40 billion on the low side without a tax cut and $60 billion on the high side with a tax cut. I don't really have a good judgment on whether there will be a tax cut on not.

CHAIRMAN VOLCKER. Do you think there should be one?

MR. TIMLEN. Do I think there should be one? For a change, I would agree with Mark Willes. But some of the numbers are hard for me to estimate in terms of the full impact of defense spending, whether out of the government or the private sector. In terms of the consumer, I just don't know how to read currently the effect of the mild winter. I would have been rather concerned about the cost of heating but I know our Buffalo branch is running considerably below budget in terms of heating that building. What the experience is in private homes, I just don't know. So the consumer may have a little uptick there.

CHAIRMAN VOLCKER. I take it that you think there's a fair amount of uncertainty.

MR. TIMLEN. I wouldn't put it in quite the same language as Mark, but I am uncertain.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. Well, Mr. Chairman, this is the last chance I get to say this so I am going to say it. In fact this is my last FOMC meeting.

MR. MAYO. Why don't you stand up, Phil?

MR. COLDWELL. No, I am not going to chance that! I agree that there's a high degree of uncertainty, but our track record and our past performance clearly indicate that we've underestimated the rate of inflation and I expect we will continue to do so. I think there's going to be a rapid defense build-up, but impacting largely upon expectations in the first part of this year. If that is the case, we may see a moderation from what the staff was [projecting] in the rate of decline in the first half. I think fiscal policy is going to be easier than portrayed by the Administration's budget. Fiscal policy is likely to be stimulative instead of restraining and I suspect we will probably underestimate the aggregate data that we are using. As for the data you've requested we comment on, Mr. Chairman, I would put real GNP in a zero to plus 1/2 percent mode, the CPI at the end of the year in the neighborhood of 14 percent, and the unemployment rate at about 7 percent. And I have already indicated that I think fiscal policy is going to be easier.

CHAIRMAN VOLCKER. So you're not in favor of a tax cut, I take it.

MR. COLDWELL. I am certainly not in favor of a personal income tax cut. I think there is a case to be made to improve the rate of business capital stimulation in the area of improving job expectations, but I would question whether this is the right time to do that. There's a fundamental fact of high inflation, which we need to continue to keep our eye on; unless that is damped, the possibilities of a rising rate of inflation are very good. I just don't find myself in agreement with the idea of gradualism in economic policy. It's a lovely theory but a practical monstrosity. Credit availability in the economy is high in my view right now. And with expectations of high inflation, the interest rate restraint is minimal. Banker attitudes reflect no feeling of quantitative restraint; to the contrary, they are seeing business as usual. I admit the majority of the bannking profession seems to say that the only thing that would satisfy them would be a major depression. But I still think we have not obtained control over this and I suspect that the recent trends in the international financial side are going to create some dollar problems for us for the coming year. As you struggle through these, I wish you well.

CHAIRMAN VOLCKER. Thank you. We're going to be left with your decision for the rest of the year! Mr. Smoot.

MR. SMOOT. Thank you, Mr. Chairman. I had very little time to prepare for this. Dave is not well and sends his best, however, to all of you. The last time I was down here I did have time to prepare a great deal and I was very confused. Now I haven't had much time to prepare very well and I am still very confused! Nevertheless, we would be somewhat less pessimistic than the Board staff's projections. To address your questions: On the real GNP, we see it negative for the year, but maybe in the range of 1 to 1-1/2 percent negative. On the CPI, we'd say up 10 to 11 percent for the year, but if I read my own charts correctly we'd be closer to 10 percent in the fourth quarter. And on unemployment, consistent with our somewhat more optimistic view on the economy, we would be in the range of 7 to 7-1/2 percent. On the tax cut, we have considered a tax cut in the second half of the year in the range of $25 to $30 billion. I would agree with Governor Coldwell that it ought to be carefully constructed to stimulate capital formation and to look at the social security tax. Other than that, I don't find our differences with the Board staff to be that great. There are a lot of marginal things that just add up to a somewhat more--

CHAIRMAN VOLCKER. If I understand you, your forecast has a tax cut in it?

MR. SMOOT. Yes, we would anticipate one. I would also subscribe to Mark's comments that differences of 1/2 or 1 percentage point at this time really appear to be somewhat meaningless.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. The staff's forecast is a bit more pessimistic than our forecast, and that largely centers on two differences. One is the saving rate, which the Board staff's forecast suggests will increase over the coming year while we believe it will be either flat or at least at a low level, thus giving consumers the ability to maintain in part their standard of living even in view of heavy inflation. Secondly, we believe defense spending will be somewhat greater than the staff is forecasting for the year 1980 coming into the third and fourth quarters; it may be $2 to $3 billion larger in each of those quarters than the staff has projected, thus giving stimulus to the economy. As a result, we would see the real GNP at about flat, zero to maybe one percent on the positive side, with unemployment someplace between 7 and 7-1/2 percent. The CPI in our judgment, however, is going to continue at a fairly rapid rate. Our judgment is that it will still be in the 11 to 12 percent range in the fourth quarter. As to the fiscal side, obviously there will be much more expansion than the staff or the Administration are forecasting. And as to a tax cut, I would agree with whoever said it would be a tragedy.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I have been concerned about defense spending as a question mark in the outlook. I must say that the chart the staff has provided us, showing an alternative with $10 billion more defense spending this year and $20 billion more in 1981 and in 1982 on top of the 6 percent real growth that's already in there for nonpersonnel costs, strikes me as a good liberal estimate of the extra defense spending that might occur or that is possible in the short run. And I would point out to you that it doesn't change the numbers all that much. I believe they did this with the model, so it includes orders effects and that kind of thing--that is, effects that occur before the actual defense spending. So, both that and the fact that it seems to me to look a little less [tenuous] than it was a month ago make me feel that it isn't such a big possible plus in the economy in the immediate future as it might have been. Also, the saving rate is just very difficult [to forecast]. New York has a continuation of a very low saving rate throughout 1980 and one could argue that there has been a permanent shift in the saving rate. I don't think so. I think it's going to come back up. I agree with the staff on that. There is no evidence of a permanent move from money to goods of the kind that would be indicated by that. So, I come down to an expectation that real GNP will fall some this year, though probably less than the staff has [in its forecast]--maybe 1 to 2 percent. The employment rate I am quite sure will rise significantly because I just don't think it is possible that services and trade will continue to add to the employment rolls without output, without a commensurate value added, much longer. So a 7-1/2 percent fourth-quarter unemployment rate is probably a reasonable forecast. I'd have inflation a little higher than the staff has--at 9 to 10 percent, say, for the deflator and 10 to 12 percent for the CPI in the year ahead. As for fiscal policy, I think there will be a tax cut but probably not until next year. That's not as early as the alternative staff projection has it, which is the middle of this year. It probably will occur in early 1981, sometime in the spring, and it will improve 1981 results a little from what the staff has projected. But I would point out to you that I think an absolutely binding assumption on the recovery of the economy is the monetary assumption which, of course, we have the ability to control. Did I get everything on this [list]?

CHAIRMAN VOLCKER. Yes. You wouldn't particularly push for a tax cut earlier.

MR. PARTEE. No, I think we ought to wait. I think it will be necessitated by a high and rising unemployment rate, and I figure that will be obvious to everybody by early next year. So it's a next year venture rather than this year. When it occurs I agree with the comments that have been made that we ought to do what we can to make it stimulative for business investment if we have any effect. But I do have to tell you that I think the full push will be to make it a consumer tax cut when it occurs.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I would like to go back to the last chart again, as Mark did. You notice those tolerance lines, the top and the bottom, are fairly narrow over the next three quarters. So it seems to me that we're looking basically at a fairly set outlook for the next three quarters and possibly into the fourth quarter, and I don't want to throw away what is one of our major advantages. The Humphrey-Hawkins Act requires us to give our outlook for this year. We have a fairly good idea where we're going this year and where we're going to end up, and our views do not differ a great deal as I hear what has been said around the [table]. It's plus or minus a little here or there, and that certainly falls within the tolerance limits of what the staff has projected. Secondly, the Humphrey-Hawkins Act says that in the middle of the year we are to reassess what we are doing. To lock ourselves into a policy at this point from now until 1981 is the biggest mistake we could ever make. We have some idea where we are going for the next two quarters or we can come pretty close to it. We have a chance to reassess it in the middle of the year. And I certainly don't want to vote for a policy at this time that is going to result in T-bill rates of 11.7 or 12.2 percent in 1981. I wouldn't quarrel a great deal with what the staff has projected. I would agree within one percentage point on almost any figure they gave us, though I'd probably expect a little higher unemployment rate than they're projecting and a little higher inflation rate, again depending on what happens primarily in defense. But if you look at the full employment surplus in the fourth quarter and the first quarter of 1981, it jumps $30 billion. And it jumps another $20 billion between the first and fourth quarters of next year. We don't have to make a decision on [1981] at this point. We have two more major decision points between now and the beginning of next year, and I think we should utilize them to the fullest. [We need to] consider the fact that we may settle on a 4-1/2, 5, or 5-1/2 percent rate of money growth and it's not going to have a great deal of influence over the next nine months. However, at midyear if we have unemployment rates of 7-1/2 or 8-1/2 percent, we must be prepared to change our policy at that point. I don't want to go down the line item by item because I don't have a great quarrel with [the forecast], but I do urge that we not give up the flexibility.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. Mr. Chairman, I would like first to turn to page 3 of this package of charts and ask a question to the staff and then make a comment. On the calculation of the high employment budget you show for 1980 and 1981, Jim: These are your calculations, I assume, rather than the official figures set forth by the Administration?

MR. KICHLINE. They're our calculations but we use the same procedure, which has been revised.

MR. BALLES. In other words, it's benchmarked at a 5.1 percent unemployment rate?

MR. KICHLINE. Correct.

MR. BALLES. All right, thank you. My comment is this: Within the last couple of years our Research Department has done quite a bit of work [on this subject]. In fact, we circulated a paper to the rest of you, just to share this view, giving an alternative noninflationary full employment rate, which we estimate to be somewhere between the high 5 percent [to] low 6 percent area, maybe centered on 6 percent. That's based on a lot of detail I won't go into, but it [involves] all the factors going into the changes in the composition and behavior of the labor force. I asked our staff to make a computation of what the high employment surplus would be if one assumed a 6 percent unemployment rate, and it produces some radically different figures. For 1980 the high employment budget surplus, [as calculated] officially by the Administration, is said to be $4 billion. But using the 6 percent unemployment rate figure, we come up with a deficit of $20 billion. Furthermore, off-budget financing, which as I understand it is not included in this high employment budget surplus calculation, would add another $17 billion. So looking at it in this alternative way, I can see the possibility of fiscal stimulus to the tune of $37 billion even on a so-called high employment basis, defined as 6 percent in this calendar year. And that, by the same reasoning, translates into a surplus of $12 billion in 1981. The reason I went through this exercise was to get a different view, depending on one's assumptions, of whether we have real fiscal stimulus or fiscal restraint or how fast we are moving from one to the other. It nets out for this year, certainly in my view, to a pretty sizable fiscal stimulus rather than the restraint officially forecast. And I think that has a pretty broad bearing on appropriate monetary policy.

CHAIRMAN VOLCKER. A part of the question, if I may just interrupt, is whatever the level, how much does it change?

MR. PARTEE. You have an improvement, John?

MR. BALLES. Yes. In my calculation, it changes from a $37 billion stimulus on the high employment basis, which adds in off-budget financing of $17 billion and assumes a 6 percent noninflationary full employment rate in fiscal 1980, to a $12 billion surplus in fiscal 1981. Now that is quite a movement. But it starts late this calendar year and [continues] into 1981.

MR. SCHULTZ. What kind of assumption do you have on normal GNP growth? To put those figures together, you need some assumption on normal growth too. Is 2-1/2 percent what you used? That's what I think the staff here is using as their assumption.

MR. BALLES. I'd have to turn to Mike [Keran]. Do you have a figure readily at hand on what we assumed for normal growth of GNP? I am not sure we assumed [something on] that.

MR. SCHULTZ. Well, you have to make some assumption to come up with the calculations.

MR. BALLES. Well, it falls out of the 6 percent unemployment assumption--a certain growth in the labor force, a certain growth in productivity, and that kind of thing.

MR. PARTEE. But you have to have a normal growth that will keep the unemployment rate at 6 percent. I don't know what Mike used, but I am sure he has a figure.

MR. BALLES. He may have a figure; I don't have it readily at hand. We'll get it for you later.

MR. KERAN. It would be the same, [2-1/2] percent.

MR. PARTEE. 2-1/2.

MR. BALLES. Turning to the other questions you raised, Mr. Chairman: Our staff forecast for the economy for this year is quite similar to the forecast of the Board's staff, showing a decline in real GNP from the fourth quarter 1979 to the fourth quarter 1980 of exactly the same amount, 2.1 percent. We have the CPI going up by 11.1 percent from the fourth quarter to the fourth quarter. Sir?

MR. SCHULTZ. That's fourth quarter-to-fourth quarter, though; that's not [the rate] in the fourth quarter.

MR. BALLES. No, that's from fourth quarter-to-fourth quarter. Our figures show in the fourth quarter of this year a rate of 9.7 percent. That is our staff view; I am not that optimistic. That is where our two staffs differ: The Board's staff sees a continued rise in the inflation rate through part of this year; our staff has a more optimistic assumption that we're at or near the peak right now.

CHAIRMAN VOLCKER. The [Board's] staff shows a decline in the consumer price index for this year.

MR. COLDWELL. Yes, down to 9.2 percent [in the fourth quarter].

MR. BALLES. Right, but I was thinking of their trend line on the GNP deflator, which is going up for a while. Our unemployment rate by the fourth quarter of this year is almost the same as theirs; ours is 7.6 and they're showing 7.7 percent. The difference in our views is that our staff is more optimistic with respect to a fairly strong bounceback in calendar year 1981, which I hope is right, up to growth of 4 percent plus, whereas the Board's staff is looking for 1981 real growth of only 2.6 percent. I am giving the staff views of our Bank. My own personal instincts are that we're probably going to have more inflation and less decline in real output than the research staff at our Bank expects. That's based on pure hunch or instincts as to what is going on in the way of a semi-wartime economy here. And my pessimism on the inflation rate--my view being worse than either staff is forecasting--comes among other things from what has been going on in long-term bond markets in this past month, which I find extremely discouraging. People are putting their money where their mouth is really in anticipation. To me that is a very dangerous signal of a rejuvenation of inflationary expectations. And it is discouraging especially in view of our demonstrated good track record since October 6th in getting a genuine, observable, real deceleration in the money supply, which I had assumed would impact favorably on inflation expectations and hence on long-term bond rates. Yet despite what we have done, we have seen a move in the long-term bond yield, which I view as a good index of inflation expectations, back up to a new high. So I'm very concerned that we adopt a posture that is a strong signal of continued deceleration of monetary growth because that is the only tool we have to combat these recently renewed rising inflation expectations.

CHAIRMAN VOLCKER. You're not advocating a tax cut?

MR. BALLES. No, sir. I support your view 100 percent.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, the Greenbook revision resulted in a move from a V-shaped decline to a sort of saucer-shaped recession, which is probably in the right direction. Despite this, I think the underlying foundations of the economy are quite weak. What strength we have had recently has come mainly from efforts on the part of households and some others to beat inflation. Now, I am aware of the argument that the rising wealth of households stemming from such things as appreciation of the value of housing may produce a wealth effect that will cause them to hold their expenditures at higher levels. But I think that is really a pretty weak reed on which to hang the forecast. Sooner or later, this artificial prop to spending that stems from inflation is going to fall apart, and an inflationary economy is not a healthy one. And if it does fall apart, then at that time I would expect, if inflation is worse, that we would have a greater decline because of the attrition of real income and the high interest rates that would discourage business investment. Also, I think we would have a clamor for wage and price controls. If, on the other hand, inflation is showing signs of abatement, then the effects of this decline are going to be diminished. So I think Chuck's observation a while ago that a lot depends on what we do is a very significant point. That will affect the outcome to a great degree. And I think we're going to have a very difficult job in the months ahead because, like John Balles, I feel we're going to have more stimulus from the fiscal side than most people seem to be assuming. But I do think we are dead serious about our stated intention to bring down the rate of growth in the aggregates, and I think we'll stand firm. But since I won't be voting next year, I have a little less confidence in that than I otherwise would have.

MR. MAYO. You want to say that again?

MR. BLACK. To get down to the figures, I think the drop in GNP might be nearer 3 percent than the 2 percent the staff has projected. Since I expect us to do well in the policy area, I would put the fourth-quarter rate in the consumer price index a bit lower, at 9 percent. I would guess their unemployment rate is not very far off; my guess would tend toward 8 percent. As I indicated, I think the deficit is understated--the stimulative effects are understated--and I certainly would not favor a tax cut at this juncture.

CHAIRMAN VOLCKER. Mr. Kimbrel.

MR. KIMBREL. Mr. Chairman, our views are not significantly different from those enunciated by the staff. To put numbers to them: For real GNP, we're looking at a minus 2 percent; for the unemployment rate, we're in the neighborhood of 8 percent; and for the CPI, 11 percent. We do feel, though, that the fiscal [package] may be considerably easier than the staff is now reflecting. We certainly would not support a tax cut unless it were directed toward capital investment. We wonder if defense spending may not be somewhat larger, particularly in the private sector anticipating [orders]. Finally, Mr. Chairman, we are growing somewhat concerned--and our concern was not lessened any by Mr. Sternlight's comments yesterday afternoon--that the market increasingly is believing that we are not slowing money growth to the extent it expected from our October decision. [Given] that and our track record in this upcoming period of the year when with tax refunds we've been somewhat less than successful in anticipating what money growth would be--if indeed we miss that as much this year and we do have excessive money growth--I have to believe that inflationary expectations are going to be escalating again and may contribute more trouble than we need. So, I hope that we will be demonstrating pretty forcefully that we expect to restrain [money] growth.

CHAIRMAN VOLCKER. You said 11 percent on consumer prices. Is that year over year or during the fourth quarter?

MR. KIMBREL. Fourth quarter-to-fourth quarter.

CHAIRMAN VOLCKER. Do you have a fourth-quarter figure itself, just for comparability purposes?

MR. KIMBREL. I guess 9 or 9-1/2 percent.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, a question [to the staff] first. Insofar as there may be a windfall profits tax, are you assuming that the revenues raised thereby will be placed back into the economy or is that pretty much outside the projections here?

MR. KICHLINE. No, it's included in the projections. The windfall profits tax--technically I think the words associated with it are "energy trust fund," but that's a misnomer if one believes that the revenues are segregated--is included in the budget figures. For 1980 we have something like a net addition of nearly $5 billion to revenues. It's something like $7-1/4 to $7-1/2 billion in revenues and $2-1/2 billion in expenditures, so it's around $5 billion net receipts. And for 1981 it's around $10 billion net receipts. So, that is included in these figures.

MR. BAUGHMAN. Thank you. I don't have a view significantly different from the staff. I think the degree of uncertainty in the outlook is not unusual at this point in time; it's probably less now than it was a couple of months ago. It seems to me that the cork is out of the defense expenditure bottle now and that that will probably go along about as fast as orders can be placed and procurement can be stepped up. That leads me to think that insofar as we may deviate from the staff projection it is likely to be in the direction of a stronger economy, less progress on the inflation front, and probably a little less build-up in unemployment. But for our purposes here, I am perfectly satisfied to accept the staff projections. If I were to shade away from them, it would be in the direction I have indicated. In addition to the defense spending, I have a view similar to the New York Bank's view that consumers are still in the process of adjusting to inflation and that the saving rate is likely to stay very low until they do see some improvement on the inflation side.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. I base my projections almost entirely on a rate of basic money growth, and the figures I will suggest are predicated on a rate of growth of M-1A and M-1B of roughly 5 percent. If there is a 5 percent basic money growth rate, I would see real GNP declining by maybe 1 percentage point fourth quarter-to-fourth quarter. I would see the GNP deflator, which is what we look at really, at about a 10 percent rate during the fourth quarter of next year, or maybe 9-1/2 percent--obviously, these percentages can vary by 1/2 point--and I would see an unemployment rate of roughly 7 percent. However, I feel very strongly that what we do will have a very direct bearing on the outcome of these figures, and if we were to set growth ranges for M-1A and M-1B at 3-1/2 to 6-1/2 percent and if growth came in at close to 3-1/2 percent, that would have a significant weakening effect on these three figures that I suggested, as we see it. In other words, GNP would be significantly lower and unemployment significantly higher. And if growth came in close to the top end of that band, at let's say 6-1/2 percent, I think we'd see a much more serious acceleration in the deflator, a significantly stronger GNP result, and a significantly lower unemployment rate. What I am driving at is that I think we have the key to this in our hands and that all three of these factors will depend on what we decide to do and how carefully and with what determination we stick with whatever we decide to do. I would personally be very much opposed to a tax cut. I would perhaps be much more tolerant of a tax cut that was an across-the-board, consumer-directed tax cut if later in the year or next year the government decided to give some tax relief directed to stimulating capital formation. I think that might be desirable but I do not favor a tax cut, not that it makes much difference in that regard what I think. But in what we do, we can make a big difference on the money growth.

CHAIRMAN VOLCKER. Mr. Winn.

MR. WINN. I think it's great that we get these scenarios out on the table. My only concern is that my camera may be in sync but it may be out of focus. So the picture that comes out may be quite distorted. But let's take several of these assumptions that we've passed over. First, the level of interest rates. I must confess that when we talk about double digit interest rates, I get nervous. But I remember that last year I got lectured by any number of people that if we passed the 10 percent rate, that was going to cut things off; and I remember after October 6th how things just dried up completely. But I think we forget that it's real interest rates that people probably take into consideration. And I have been amazed at the amount of money coming out of the woodwork in the last two weeks of January and the number of deals that are being formulated with respect to apartment houses, hotels, commercial buildings, and so forth. The amount of money that is being committed in this area has stepped up tremendously after this hiatus. I think we see it in the bond market, John, in terms of their attitudes. Some of the current financing I think is being done to repay short-term debt. There's an awful lot of talk going on with respect to financing, but that's not going to come into the investment picture until the last half of this year. And that being laced on top of defense expenditures, should they come along, makes a little different scenario for this year's [performance].

One other thing: In terms of your employment figures, have you put anything in there for a possible draft or increased military employment?

MR. KICHLINE. No, we have not.

MR. WINN. If you do this, you get a different scenario. Again, this doesn't occur over night but it is another factor that seems to me is down the road.

CHAIRMAN VOLCKER. What was "this"?

MR. WINN. If you put a draft in the picture, then it changes these employment figures.

MR. PARTEE. Probably in 1981.

MR. WINN. It's probably down the road; I don't say it is immediate. But, again, as one [looks at] various scenarios with some different inputs, there are different results, obviously. While housing is down, I too am amazed at the amount of money that is even showing up for housing at the moment. So, as I look at the level of rates, I go back to looking at availability; and I get nervous as to what [level of] interest rates it will take to have a damping effect on some of these [sectors].

In my scenario, I come out with a dip in the first half of this year because I think it's already under way. But I can see some revival in the second half, so that I get a 1 percent decline for the year but it's quite a different shape. The price [situation] really scares me. Go back and look at 1973 and 1974; maybe we're going to multiply that distortion created by prices. And if the world situation changes, some of the pressure for relief could come next year--I think it's already under way for this year--and carry through for a while. But we may be [unintelligible] upswing continuing through part of 1981 and then real price distortion problems hitting us by the end of the year. I see price problems in the 15 percent [CPI] rate; that is going to give rise to increased wage demands and re-opening of contracts and all kinds of pressures and we don't know how that is going to factor through to the balance of the year. And that's not in your scenarios, in terms of the wage assumptions that you put in. One gets different price results with some of these different assumptions. So I am even more concerned about inflation developments and what they mean not only for 1980 but perhaps for 1981 and thereafter. And that has implications for the international side and a whole host of things, which change the [scenario]. I think the pressure for a tax cut is going to come both with the election problem and the first half year results. That will further complicate the problem and I would be opposed to it. This would be in my scenario, Paul.

CHAIRMAN VOLCKER. Did you have an unemployment rate or a price [forecast]?

MR. WINN. I get an [average] unemployment rate from the fourth quarter to the fourth quarter of maybe 7 percent, but I think it will probably go higher before it comes down unless we get a draft and some other things that would change my numbers. I don't know what is going to happen, but you get a different picture if you change your assumptions.

CHAIRMAN VOLCKER. You're in the high uncertainty group?

MR. WINN. Very much so.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, we ought to be recorded as generally supporting the Board staff's projection and its numbers. However, unlike most of the others, if the forecast is in error, I think it will be because the recession could be substantially more severe than they are projecting. We had a miss in our forecast in the last half of 1979 because consumer behavior was much stronger than we were forecasting on the basis of income growth and so on. This has led New York and Kansas City and perhaps some of the rest of you to look upon a 3 percent saving rate as a norm for the future. I think it is also possible that when the unemployment rate starts rising the consumer will turn defensive and we will see the saving rate rise higher than the Board staff has projected and a bigger recession will result. Also, the housing sector could be weaker than the staff has projected. We don't really yet have a good fix on how the current housing rate structure is impacting demand. But the Board staff has the weakest quarter at 1.4 million starts. It seems to me that we could see at least one quarter substantially below that. So, I think we have a risk of a much sharper recession in 1980 than the Board staff is projecting. It's a risk, but I can't attach the probabilities to it.

As far as defense spending is concerned, we've talked to the major defense contractors in the Boston area like Raytheon and others, and they say that for the kind of hardware the Defense Department is talking about most of the money will be going into long lead time items. And while we may get a big effect on expectations in 1980, they don't see a big effect on employment until 1981, even if the program were to get geared up fairly soon. So, it seems to me that we could see a different pattern: a very sharp recession followed by a tax cut, an increase in the defense budget, and a big jump in 1981. That's another hypothesis that hasn't been stated around this table.

CHAIRMAN VOLCKER. We'll get every hypothesis on the table! Governor Wallich.

MR. WALLICH. It seems to me that the odds have clearly moved in the direction of less recession and more inflation than they were some time ago. I think the degree of uncertainty is very high because the saving rate is abnormal and, therefore, potentially unstable. And if we move to higher rates of inflation, people could react very unpredictably. But the thing that most impresses me about the behavior of people is that in the last surge of inflation, in 1974, the saving rate went up--and it did so not only in this country but all over the world--while this time people have reacted differently. They pulled the saving rate down. That seems to be a message. They seem to be saying: "We're no longer so scared of losing our job that we're stopping our spending. We're now out to beat the game." And that suggests to me that we may be in a new ball game unless the move to higher inflation rates throws a new scare into people.

Well, I had anticipated a somewhat more severe recession than the staff, but recent events have taken me off that. I could see a small dip in 1980 of maybe 1 percent, but [my forecast has] a very wide variance. I see inflation now at very high rates, with the deflator at 12 percent for the year, that is year-to-year. And the CPI could be close to 15 percent. These [increases mean that] real interest rates are no longer positive. I know that some of us don't believe that real interest rates mean very much. But we're only 19 people and there are 220 million out there who believe differently or at least act as if they believe differently. So I share what Phil Coldwell said on that score. I don't see quantitative monetary restraint being in effect--that is, availability restraint. And I don't think that these interest rates, particularly when one considers them after taxes, really bite. So we have to consider now that we are in a group of high inflation countries with Italy and the United Kingdom. Then comes a tier of moderate inflation countries and then come the low inflation countries. We've moved very far. That is why I don't really expect a tax cut this year. I think these forces will give people pause unless there is a significant deterioration in the climate. Eventually, I think there will be a tax cut simply because we are getting more fiscal drag than we can accommodate over time. I certainly would oppose a tax cut, and I would lean toward firm monetary restraint. I don't know [how] one can have that confidence in the nominal aggregates that M-1A and M-1B convey. All we know is that these [measures] are extremely uncertain. I don't think the new definitions capture all that's going on, especially in the Euromarket. We capture only a small part of that. So I believe money is really expanding faster than we think, and I would want to take that into account in thinking that we can have 15 percent inflation. On unemployment, I have no difference with the staff; 7-1/2 percent by the end of 1980 seems a possibility.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. First, to go back to the charts for just a minute: I greeted with some astonishment the chart on unit [labor] cost indicators where output per hour, having deteriorated badly from the beginning of 1976 to the present or the last available quarter, suddenly takes a new spurt of enthusiasm and becomes positive. And your unit labor cost, of course, shows just the opposite trend. I would like to believe this, but I am not sure what the staff has based it on.

MR. ZEISEL. Basically it is associated with our assumptions or conclusions about more rational behavior by employers in regard to their staffing. The deterioration in productivity is the other side of the coin of this tremendous increase in employment relative to the lack of growth in output. We're anticipating that the pressures of rising costs and the evident lack of strength in markets over the next couple of quarters will persuade employers that they are overstaffed and that, therefore, they will be laying off employees and trying to bring their costs better into line, which will show up in a somewhat improved productivity performance. But as you will note, we have negative productivity throughout 1980. It just isn't as bad as it was in 1979.

MR. MAYO. In effect, you're suggesting that whatever labor hoarding has taken place to date really isn't going to continue. And that's one of the reasons your unemployment rate is moving up as much as it is. Is that correct?

MR. ZEISEL. That is true, yes.

MR. MAYO. My other question on the charts relates to defense spending. Frank stole my headline on that by his mention of long lead times on defense contracts. I find the assumptions both in the budget and in your table on real defense spending unreal. I don't think it is possible unless there is an awful lot of shelf items involved--more than I can imagine--to add 6 percent to real defense spending in the remaining six months of the fiscal year. And that's all there is left in this fiscal year. We have a history over the last 30 or 40 years of projecting increases in defense spending prematurely, and I think this is happening again in the budget figures and in the staff forecast. Instead of being up 7 percent and up 8 percent or whatever is shown on this chart, I would say it's more likely to be up 2 percent and up 12 percent. So, that would affect the attitude toward these figures in 1980. On the other hand, I would support the total that you have in your staff forecast because I think it's more likely to burst out on the nondefense side in light of other factors between now and the beginning of the new fiscal year. Now, that doesn't mean there isn't an attitudinal and expectational response. But I think it stems mostly from the evaluation of the inflation and the real GNP outlook a year ahead, rather than manifesting itself in defense spending in the fiscal year of 1980.

Having said that, I won't repeat Mark's caveats, but in terms of point estimates I really don't have much quarrel with the staff forecast on real GNP. As for the probabilities, I would say the probability is that there will be less growth--in other words a bigger decline, net, than the [minus] two percent the staff has--maybe a [minus] 3 percent for the year. I am not quite as pessimistic as Henry, but I will take shelter under his umbrella on the price index. I don't think there is more than one chance in ten that we can get down to 10 percent on either the CPI or the fixed weighted deflator by the fourth quarter of this year. The chances are very good--I hate to use the word "good" that way--that it will still be above 10 percent. On unemployment, despite my question on the labor hoarding problem, the chances are unfortunately also very good that unemployment will be above 8 percent because the inflation rate is so sticky and so built into consumer expectations that I think this is the way it's going to crank out. No tax cut, please.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, what I wanted to say was said by Frank Morris. I have no reason to argue with the staff forecast with respect to GNP, the unemployment rate, and the CPI. Given what we know today, these projections seem to me to be the most probable outcome. But, I suppose like everybody else, I do have some worries; and one of them is the cumulative effect of the erosion of disposable income on consumer expenditures. Consumers may well be prepared to spend less than has been projected in the forecast. And, of course, if that happens, there will be further consequences for the economy. Now, this may well be offset by the buildup in defense expenditures toward the end of the year. So there is some uncertainty. But I do worry that the possible shortfall in consumer expenditures may well make the recession more severe than is projected. I also worry about the cumulative effects of a restrictive monetary policy. If we are successful in damping inflationary expectations, the reaction may well be stronger than we now see, and this may also operate to make the recession more severe. But these are just vague worries; I have no data to support them. And for the purpose of making suggestions as to monetary policy, I am prepared to accept the staff's forecast. As for a tax cut, I would be opposed to a tax cut at the present time. However, depending on how things emerge in the future, a cancellation of the anticipated social security [tax increase] package could well be an appropriate measure. But that judgment would await future developments.

CHAIRMAN VOLCKER. Governor Schultz.

MR. SCHULTZ. Well, as everybody around here is aware, I have had a high degree of uncertainty about what was going to happen. I have a little less right now, so far as my feelings about the near term are concerned. I see three areas of weakness. First, I think the economy is a little weaker than the numbers will show in January because the weather in January was so remarkably good all over, and I think that had a considerable effect. I am seeing some areas of restraint that are secondary kinds of reactions to the October 6th [action]. In the area of consumer credit, more and more banks are cutting back on the availability of consumer credit and are increasing the price and other factors. We're also seeing that with [credit extended by] retail establishments; Sears and Penneys and others have recently made those kinds of announcements. So, I think we are seeing some restraint that hasn't been there before and the pressure is increasing in that area. I do not think that we have seen the low in housing. I agree with Frank Morris that it's going to go lower; it could go considerably lower. We saw that chart on the commitment rate, and my understanding is that the situation may be even worse than that chart looks. And that's bound to begin to spill over into housing durables pretty quickly. It hasn't done that much yet. As far as autos are concerned, I don't see anything that is going to bring them back very fast. Things may have to get worse in that area, partly as a result of the [tighter] consumer credit and partly because gasoline prices are going to continue to go up. We see that there is more conservation than we really thought. People are more concerned about [gasoline prices], and I think it's going to have a big effect on their purchases of automobiles. So, I don't look for any strength there in the near term.

On the other hand, longer term I see some areas of strength that may be stronger than the staff assumptions. I disagree with Bob Mayo on the defense side. The reason I do is that we're looking at all of the news reports that say this involves sophisticated weapons and there's a very long lead time. We are not looking at the operations and maintenance side. My understanding is--I have just seen some recent figures--that the Pentagon is estimating that for ammunition alone they need more than $20 billion. Now, ammunition is something that can be produced pretty quickly. So I think we may see some faster impact on the defense side. The other area is the tax side. It is an election year. I do not favor a tax cut this year; I would, I think, next year. But we may get it this year. If you look at the staff's chart "fiscal alternative-tax cut" and see what a politician would see--that with a cut in payroll taxes he can have the best of both worlds, better growth in GNP and lower inflation, which is what that chart shows--that's very attractive to a politician. And I just think that we may get enough weakness in this first half to make a tax cut much more likely this summer. So, my figures are a little stronger than the staff's: GNP down 1 to 2 percent;

unemployment 7 to 7-1/2 percent; and the CPI in the fourth quarter a little worse than the staff's, at 10 to 11 percent.

CHAIRMAN VOLCKER. Well, I have missed one personal objective of speeding up the coffee hour appreciably. But since we're short of 11 a.m., let me make a couple of observations. I do have the feeling in listening to some of the different economic forecasts and comments that our staff, which is sometimes accused of being Keynesian, feels more constrained by the money supply assumptions than more monetarist-oriented people. And that accounts for some of the differences in view. Assuming that we're all intelligent people around the table, [given the] differences in outlook that have been recited, I don't see how anyone can come to any opinion other than that there is a great deal of uncertainty in this forecasting business.

In terms of what we have accomplished or have not accomplished in monetary policy in recent months, particularly as reflected in expectations as best one can judge them, we have to conclude that we've been [set] back very substantially and have suffered a grievous blow from everything that has been going on internationally--whether you're talking about oil prices, or Iran, or Afghanistan and concern about defense spending. There's nothing much we can do about that, but I think in some sense we're back to square one or worse in terms of the public's concern about inflation. So I tend to agree with those who see a risk of an inflationary breakout, in modified terms, on the up side as a real danger. I also agree with Emmett Rice and a couple of others who said that we could get a longer reaction in the economy on the down side if that happened. I don't know what we can do about that. We can't deal with both situations at the same time. In fact, I don't think we can deal with the risk of a downturn and ignore the inflationary side, because they're part of the same parcel in some sense.

I feel rather strongly that it would be a great mistake to put much money on any particular forecast at this point. I come back to what Mark Willes said at the beginning, and I think the saving rate question is a perfect illustration. I can hear persuasive arguments around this table as to why it is going to go up and I can hear persuasive arguments as to why it is going to stay down; and I don't know of any criteria by which I can choose between those two choices at the moment. In a direct statistical sense that will be the most important influence on the economic outlook in the near term. There are a couple of other things that might be mentioned that haven't been touched upon. We have some uncertainty about tax refunds in the near term, with some expectation that they may be very high relative to past experience--I am talking about [the time period] between now and April or beyond--and what that will do to the near-term timing of consumer spending. What it will do to the near-term timing of the kind of forecast the staff has I think is an unknown. If one assumes some lag in defense spending but also assumes that the option of high defense spending is going to come along [later], we could get a pattern of big refunds for a while, in a sense artificially holding things up, followed by a defense impetus coming late in the year and taking over after the refunds subside. It only adds to my feeling of caution about any forecast.

So far as the bond market and the banking system and the availability of credit are concerned, I'd just make two observations.

I think the bond market people, who from the way they are behaving apparently are quite discouraged about the inflationary outlook, have concluded that money is freely available. I see one side of it. But also, in talking to some bankers, I think there is something to what Fred Schultz just said about a cumulative impact of restriction. That's beginning to be felt by some bankers, who have talked to me, anyway, not only in consumer lending but in mortgage lending and in small business lending and other types of lending. I think it is true that the last ones to feel that are probably the big companies that have access to the bond market and to the banks, too. I don't think the picture is all one way. There has been great confusion about--I guess it was John Balles who said it--whether the money supply is genuinely [or only] statistically under control. I think it is statistically under control. I am not sure the market thinks it is genuinely under control. And it comes down in part to some confusion over our own operations. I meant to mention earlier--and I don't know whether the presidents have seen it--that we put out an elaborate technical explanation of what we're doing, which Mr. Axilrod authored. It has gotten no attention in the press thus far, but it was an attempt in considerable part to meet the questions that have been arising about why reserves are going up 10 percent or 12 percent or 8 percent, depending upon which number you're looking at, while the money supply is going up 3 or 4 percent. I don't know whether we will convince anybody as that seeps into consciousness. But there has been great confusion engendered by the differences in growth rates among all these measures, including right now the various reserve measures going off in widely different directions. I will leave you with that.

Let's have the coffee break and when we return get back on these long-term and short-term targets.

[Coffee break]

CHAIRMAN VOLCKER. I think we can start. Let me make a couple of preliminary remarks and just devote our attention to the long-term ranges at this point. One preliminary remark is that, whatever we do, I am afraid that we inevitably are going to have quite a lot of confusion with the changes in definitions [of the monetary aggregates] coming at the same time as [the setting of our] targets. We are going to have a press briefing, not to give the targets, but to explain the changes in definitions and the changes in patterns. We have had to add to all our other complications the usual annual revision in seasonal patterns. We can now go forward and talk about the new numbers but we are talking about them against the background of an increase of almost 5 percent in January, if we can switch our minds now from 1-3/4 percent or whatever was projected before on the basis of the old numbers. The new M-1A and M-1B are growing at something like 4-3/4 percent in January, as I recall, which is pretty much on the target that we set for ourselves by the grace of a revision in seasonal adjustments. If policy fails, we can always revise the seasonal adjustment factors for a while! [Laughter]

MR. SCHULTZ. Well, we may have to consider it; it may be more important than lagged reserve accounting!

CHAIRMAN VOLCKER. I do think this is going to be troublesome to explain, but we inevitably have to do it. Another complication, which we don't have to face right now, but it is inherent in this situation, is that basically the reason we have both M-1A and M-1B is to allow for growth in NOW accounts, and that [dichotomy] is a transitional device. The staff's judgment is that growth in M-1A and M-1B will not be any different this year if the law legalizing NOW accounts doesn't pass. But the high probability is that that law will pass, presumably sometime during the spring, and that we will have to re-estimate M-1A and M-1B to allow for that; I presume we would want to make a technical adjustment in the targets. I don't think we have to worry about that now--maybe we can wait until midyear for our regular revision anyway--but I just warn you that sometime during the spring, I suspect, if the law does pass, we think there will be a significant difference between M-1A and M-1B and that some suitable changes will have to made, if nothing else, consistent with what we decide today.

On the substance of the matter, if it is true that we face a wide disparity of views in what the outlook might bring and a high degree of uncertainty, I suspect we are on an approach--whatever other merits or demerits there may be--that will provide us with some fail-safe protection. [By that I mean] that if the economy really goes down hill, almost any figure within the range of what we have been talking about should produce an easing in the outward externalities of policy, but if the fears of a stronger economy and an inflationary surge appear, the opposite ought to happen. And I presume that in a very crude way, anyway, either of those results would be appropriate. When we discussed this the last time, there was a consensus--and maybe for a variety of reasons it was not quite unanimous--or a strongly predominant view to maintain a 3 percentage point range, and all these alternatives are couched that way. The ranges in the Bluebook fully encompass all that people were talking about last time, I think. The differences in the ranges are not very wide, as you know, and nobody is bound by what he or she said last time. To orient you a bit: It was not true for everybody but the predominance of views fell between the alternative II and alternative III choices shown here; and there was actually some plurality if not a majority for alternative III. But people were talking in a preliminary way and rather loosely. My own feeling is that we probably [should] end up in that area, and I don't have enormous feelings that a difference of 1/2 percentage point is of great significance. When we are in that area, the strength of my views is not pronounced among [those alternatives]. But judging from the discussion last time, we are predominantly in that area. So with that introduction, who would like to be more precise in stating their views about where we should be for the annual range in 1980? Mr. Black.

MR. BLACK. Mr. Chairman, my feeling hasn't changed a lot since our last meeting. It is true that the economic outlook has changed somewhat from what most of us expected. In particular, the government's demand on resources appears likely to be much greater than we earlier thought. But far from providing the reason for relaxing or delaying this long-run task of ours of lowering the rate of growth in the aggregates, the inflationary dangers posed by this fiscal stimulus suggest to me that the System needs to stick all the more firmly to the goal that it has often stated in the past. The midpoints of alternative II look good to me. I was one of those who preferred the narrower ranges last time. I would much prefer a 1 percentage point range for M-1A and M-1B and a 2-point range for the other aggregates, M2 and M3, because of their interest volatility.

Now, one can certainly argue that we need more flexibility since we may be moving into a recession and we may be moving into more inflation. I recognize the validity of that argument, but it seems to me that the narrower range would do a lot to enhance our credibility. Therefore, it would enhance a great deal the beneficial expectational effects that I think we'll get if we do in fact announce lower targets than what we have achieved in the past. I would be rather unhappy if M-1A and M-1B, which are the two aggregates I consider most important, came out at the top of their alternative II ranges. So, my figures would translate to 4-1/2 to 5-1/2 percent for M-1A, with a midpoint of 5 percent, the same as in alternative II. My other ranges would be: M-1B, 5 to 6, with a midpoint of 5-1/2; M2, 6-1/2 to 8-1/2 with a midpoint of 7-1/2; M3, 7 to 9 with a midpoint of 8; and bank credit, 6-1/2 to 8-1/2 with a midpoint of 7-1/2.

CHAIRMAN VOLCKER. Let me just say a word. You reminded me about M2, M3, and bank credit. First of all, I'd just note that if people feel strongly about the weight to be put on those numbers, they ought to say so. Secondly, in the normal course of events, given the way we are operating they may get a little less weight than they have in the past because we won't have those figures as up to date. So far as I am concerned, I take on faith the staff analyses of the consistency of the particular ranges they put down for those numbers as compared to M1. I don't know of any strong reason why they should be different from what the staff put down, but I have a little residual suspicion that those are indeed more volatile numbers than the M1 numbers because quite a lot does depend upon the evolution of interest rates, and I don't know in which direction they will go.

MR. BLACK. Well, I have said most of what I felt along that line. I would emphasize M-1B because it catches the transaction balances better; M-1A has lost a lot of the transaction balances.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, Mr. Chairman, last time I indicated some preliminary specifications that would have been consistent with alternative II. I want to argue this morning for alternative I. That's a difficult thing to do and I have always found myself unsuccessful in such arguments in the past. But let me try it once more. The staff projection for nominal GNP, fourth quarter-to-fourth quarter, is for a 7 percent increase. The direction of thinking as we went around the table was to convert that to a somewhat higher nominal GNP increase because almost everyone thought inflation would be a bit higher than the staff has projected, and quite a few people thought that the decline might be a bit shallower than the staff has projected. So I would say that the Committee view, as opposed to the staff view, is that nominal GNP will increase at least 8 percent. And I believe the Administration, Jim, has a 9 percent increase in nominal GNP fourth quarter-to-fourth quarter. In drawing these long-term ranges, the relationship between money growth and the nominal GNP is of central importance because it really indicates the amount of tension there's likely to be in markets as the year goes on. And even 7 percent [for nominal GNP growth] with a 5 percent midpoint on M-1A and 5-1/2 percent on M-1B, which is alternative II, does imply an increase in velocity of a couple of points. If, in fact, we think nominal GNP [growth] is going to be a little higher than that--let's say 8 percent instead of 7 percent--it seems to me that as a matter of practicality and credibility in achieving the targets we set, we ought to recognize that a bit in the specifications we pick. Going from alternative II, which had been my former choice, to alternative I adds 1/2 point to the midpoint. It makes the midpoint for M-1A 5-1/2 percent and that for M-1B 6 percent, compared with, say, an 8 percent nominal GNP, and I think it does suggest a very considerable tension on markets throughout the year. And it's [a target] that we might be able to achieve.

I would point out one more thing: Every private forecast that I have looked at, and I just reviewed them yesterday, suggests a federal funds rate at the end of this year of 10 percent or below. The only exception might be Salomon Brothers, but they don't specify the funds rate in their projection. We are suggesting something around 13 percent. The difference, I think, is in the implied increase in money in the private projections, which is stronger than we have. Now, if we go through a recession and hold the interest rate up throughout the recession--hold it pretty close to where it is now--start a recovery, say, a year hence or thereabouts with a rising trend of rates and high unemployment, we will have done really quite a lot to restrain the economy [through] monetary policy compared with any past cycle that I can recall. And I think that also argues for being just a bit more liberal so that we'll have something we can achieve. I understand fully what Bob says about narrowing the ranges, and I do agree that there is quite a difference between, say, 4 percent and 7 percent in M-1A, [which are the limits] in alternative I. But in the interest of again being able to achieve growth this year within the ranges we specify, which we managed to do for the first time in our history in 1979, I think we need to hold the width of 3 points that we have had but try to [achieve] the midpoint of the range. So, I would come out with alternative I for the reasons that I have explained, and I would stay with the 3-point range.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I agree with those who have argued, starting with Governor Teeters and others, that in view of all the economic uncertainty, we do need a lot of flexibility as the year unfolds. And for reasons that Chuck has just reviewed, I would support the idea of having a 3-point range. As I often do when we get to this time of the year, I like to speak to the two faces of the ranges that we are discussing here. The one face is the public reaction or the announcement effects, for what they are worth. They may not be worth a lot, but I can't believe they have no effects at all. I admit, as Ted Truman pointed out to us yesterday, that the public pays more attention to what we do than to what we say we are going to do. But reverting to my earlier deep concern about an apparent re-escalation of inflationary expectations over the last month--[manifested] in various ways, especially in the rise of long-term bond yields to new highs, as I pointed out--I think there is a lot to be said for picking ranges just in terms of public announcement effects that are both broad, because as I have already indicated we need the flexibility in view of the economic uncertainty that lies ahead, and that would tend to ensure that we do in fact get continued deceleration in monetary growth. Our record since October has, in fact, been very good on that. But I am afraid that there's some skepticism among market participants and others that we may not persist. One way of putting that skepticism to bed, or at least helping to diminish it, would be to have upper limits on our ranges which even if hit would still involve slightly less monetary growth in 1980 than in 1979. For that reason, I would support alternative II with respect to both M-1A and M-1B because even if we hit the upper end of 6-1/2 percent in the case of M-1A, that would be less than the 6.8 percent growth of last year. And even if we hit the upper end of the alternative II range of 4 to 7 percent for M-1B, growth would be less than the 8 percent growth we had last year. And for the same reasons, I would choose the alternative III ranges for M2 and M3. The upper end of the alternative III range for M2 is 8-1/2 percent, below last year's 8.8 percent actual. In the case of M3, the alternative III range of 6 to 9 percent is below the 9-1/2 percent actual we had last year. So if there is any sense at all in what I am saying about the public perception of the maximum [rates of growth] we specify, assuming that under our new operating procedures we didn't exceed the upper limits of the ranges, those upper limits would involve at least a 1/2 point decline from the actual rates of monetary growth in 1979. As for whether we should target all four of these, Mr. Chairman, I have grave doubts. I think M-1A is still so influenced--or perhaps contaminated, to use a word my research staff is fond of using--by past and ongoing institutional changes that I personally would be prepared to drop it right now and put our faith in M-1B.

CHAIRMAN VOLCKER. I don't think there's much difference between M-1A and M-1B, barring this legislative change; the difference is a small number.

MR. ROOS. I found more to the change [unintelligible]. I think there was some confusion last time. Wouldn't M-1B--

CHAIRMAN VOLCKER. They both will. The problem is that if we get the law change, M-1B will rise both because it's taking [funds] out of M-1A and out of M2.

MR. AXILROD. Only because it's taking funds out of M2.

CHAIRMAN VOLCKER. Yes, it will only rise because it's taking funds out of M2. M-1A will go down. [M-1B] will rise because it's taking out of M2; and M-1A will decline because [funds will be taken] out of that aggregate.

MR. BALLES. Well, in short, I would like to make a pitch for targeting M-1B and M2 as opposed to targeting M-1A and M-1B, [as suggested] in the draft directive language. Our own experience in the past has led us to place somewhat more confidence, in terms of the old definitions, in M2 as a predictor of inflation and real GNP. Of course, it remains to be seen whether that is going to hold for the new M2. But based on some of the statistical tests that we've done, M-1A is certainly the least reliable predictor of real GNP of the four aggregates mentioned. The differences are quite significant, and that's why I am somewhat disillusioned about M-1A. We've tested it retrospectively and view it as a considerably poor forecaster of future real GNP. That is the main reason I would like to drop it. Those are my recommendations, Mr. Chairman.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I think we face more inflation and less recession than would have been [the case] before recent changes in the economy. Now the question is: How does one finance a higher nominal GNP with a given amount of money supply? In Chuck's calculation you have to look at the nominal GNP and ask how it can be financed from the rise in money, and a rise in velocity is very logical. Moreover, one can't say nowadays that we would get some rise in velocity out of rising interest rates because presumably we wouldn't. So we're dependent, really, on the amount of money growth in the effective money supply--that is, the amount of money growth plus the regular growth in velocity at a constant interest rate. And I think the staff puts the drift in the demand function at about 2 percent.

Since we've opened up the question of the aggregates, I would like to express some doubt not only about M-1A, on which I share what others have said, but M-1B. In general I think we are not yet including everything that acts like money, and we probably never will. Money market accounts and mutual funds are not in M-1, although I would suspect that they have a very strong effect on people's holdings of demand balances. That is, they aren't used for transactions--their velocity is low--but they are very good substitutes for a cash balance. I hear that brokerage firms are now setting up, in effect, zero balance overdraft facilities. If that takes over, one needs no cash balance at all any more; one can just finance one's current needs against one's stock holdings. There are Eurodollars, of which we [include] what seems to be a small part in the aggregates. I don't think we capture even all the Eurodollars owned by U.S. residents because we don't know their total and we certainly don't include any part of Eurodollars owned by nonresidents, even though one would think some of those dollars are going to be used in the United States, not for purchases of goods and services but for purchases of assets, which influence our interest rates and so on. So, I think the monetary aggregate [targets] are really symbols of restraint--orders of magnitude, but not to be taken at face value. If we did take them at face value, I'd say look at M2 and you will find that under alternative I [the staff] projects [growth at] 9-1/2 percent, the upper limit. That's more than [the projected] nominal GNP increase for 1980, which I believe is about 8 percent, so we'd be over-financing in those terms. This does not allow for any drift in the money function.

MR. PARTEE. There's no drift on M2.

MR. WALLICH. There may be no drift in M2, but that depends on how one believes these extraordinary items, Eurodollars and so forth, impinge. Well, that leads me to alternative III. I think we do need wide ranges because it's simply impossible to target several aggregates and make them consistent using anything like a single number. I would place a great deal of weight on M2 for the reasons I have given. I think [alternative III] is consistent with financing [a nominal] GNP increase of about 8 percent.

CHAIRMAN VOLCKER. Mr. Willes.

MR. WILLES. Thank you, Mr. Chairman. I just couldn't disagree more with some of the comments I have heard and I agree entirely with some others. Chuck and I have this running discussion about how we finance nominal GNP. He has his view. My view is that if you try to do [it his way], you just chase your tail. If in fact there is a relationship between money and inflation, by persistently trying to finance nominal GNP we end up generating more inflation--even at an accelerating rate--which therefore we have to finance and so on. So I would hope we would not take that [route].

MR. PARTEE. Oh, I don't disagree with that. It's a question of whether one thinks this [degree] of weakness in the economy is reasonable.

MR. WILLES. That's right. Now, what I find most puzzling--and I will copy one of Fred Schultz's lines, which I always thought was mine, and that is that I have a very simple mind--

MR. SCHULTZ. Well, some of us will agree with that!

MR. WILLES. I would think, if we agree that the outlook is very uncertain, that rather than arguing for more flexibility we would argue for less. That's because if the time pattern of the economy is very unpredictable, then there's no way we can respond to change it in a predictable way and, therefore, we ought not to be responding. We ought to respond less rather than more, the greater the uncertainty about the outlook. As a consequence, unlike Nancy's and John's earlier suggestion that we do all we can to preserve our flexibility, I would say just the opposite. I think we ought to pick a path that we want to follow for the long term and stick to that path as long as we can unless we receive major information that suggests we're way out of [line] for one reason or another. Of course, rational expectations would say that even if we got such information, it's not clear we could do anything about it and, therefore, we ought not to respond. Having said all that, obviously, I would much prefer the specifications of alternative III. That looks like a very large drop for M-1B from [growth of] 8 percent in 1979 to [a range with an upper limit of] 6-1/2 percent in 1980. But the Bluebook says on the previous page that for the last six months M-1B growth has only been 6.1 percent, so the drop isn't as big as it might appear from the [table] on page 6. So, I would go with alternative III. I must say I am in the group that thinks the range is too wide. I would be concerned if money [growth] dropped, assuming we are measuring anything corresponding to money, down to 3 percent. On the other hand, I would certainly hate to see it above 6 percent. So, I'd prefer a narrower range but would not want growth to go above 6 percent on M-1A or 6-1/2 percent on M-1B.

CHAIRMAN VOLCKER. There's a [trickiness] of these figures. I think it's fair to say that M-1A was artificially high last year because we did get some transition [flows] into NOW and ATS accounts, part of which came out of M2. Mr. Kimbrell.

MR. KIMBREL. Mr. Chairman, one specific thing I would like to see is that the 1980 targets be related to the 1979 targets and not the 1979 results. We are all [talking about] the uncertainties. Of course, there does not seem to be much uncertainty about [the risks of a] recession and all of us are accepting that there are going to be inflationary tendencies and expectations. And I feel that our actions should attempt not to provide any unnecessary opportunities for strong money growth. I would hope that we indeed will begin to lower these monetary goals gradually. For that reason I also accept the thesis of narrower ranges, not more than 2 percentage points, and frankly with a strong determination to achieve them and control [money growth]. So I would [narrow] the alternative III ranges and I end up with 3-1/2 to 5-1/2 percent on M-1A, 4 to 6 percent on M-1B, and 6 to 8 percent for M2.

CHAIRMAN VOLCKER. Mr. Smoot.

MR. SMOOT. Governor Partee argued for alternative I, based on the higher anticipated nominal GNP. Looking at my own staff's projections, our nominal GNP figures would be somewhat higher than the Board's. But they also encompass a money supply growth rate in the 4-1/2 to 5 percent range. Depending on which one of those I pick, I am indifferent between alternative II and alternative III, which I think is where you were, Chairman Volcker. If I had to choose, I would choose alternative II based on the observation, which is made quite clearly in the Bluebook, that all of these alternatives suggest a lower rate of growth in money than occurred last year. And if we pay any attention to the long-term trend in money growth, then we are coming down from a higher trend level. I must say that I have faith, as you do, that the staff's ranges are consistent; at least the numbers for M-1B, M2, etc., appear to be consistent, and I wouldn't quibble with those. So, based on that, we would be agreeable to alternative II.

CHAIRMAN VOLCKER. Mr. Mayo.

MR. MAYO. Mr. Chairman, unlike the humility of Mr. Schultz and Mr. Willes about being somewhat simple-minded, I must be humble in saying that my mind finds things very complicated. I have tried hard to move toward being simple-minded on some of these things. We have different approaches to some of these problems. However, I find that the factors are so complicated and have such a margin of error that I must stick to the 3-point range. Some people might accuse the Fed of being a bit cowardly because the range is so wide. But the factors that we are dealing with are indeed so complicated that we must allow ourselves this flexibility. I feel, if anything, even more strongly than John Balles put it that we are [making this] unduly complicated. Again, I am striving toward being a little simpler. We are making it hard, and even harder for you, Mr. Chairman, when you try to explain to your audience on Thursday why we have decided to use both M-1A and M-1B when both of them will need adjustment when we get NOW accounts. And I agree we will get them nationwide. I think we'd look a lot more sensible to forget M-1A--as I said last time and I'll say it again this time--and call it M1, show some change, and not give the impression by stressing M-1A that the lion has labored and has produced a mouse. There's too little change from the old M1 in what we are proposing, and I would rather see us stick with M-1B and give the explanation of the adjustment in NOW accounts in a simple-minded fashion rather than try to adjust both M-1A and M-1B to NOW accounts when they come. This is the way in which my attempt to be simple-minded would direct us. I'd prefer alternative II with the 3-point range. I'd obviously prefer to concentrate just on M-1B and call it M1, [with a range of] 4 to 7 percent.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Chuck Partee has moved from one recommendation to another from last month to this month and I will also, but going the other way. Last month we were looking at a somewhat weaker economy and it seemed that perhaps the inflation rate would fall off a bit through 1980. Also, the deceleration from what actually happened in 1979 to what I would like to consider our target --the midpoint [of any of] the ranges [we select]--from about 7 percent [growth] to 5 percent for M-1A, for example, seemed fairly fast. And that is the reason last month that I would have opted for what now appears to be alternative I. But things have changed, at least to my mind. We're now looking at a bit stronger economy through 1980, as I tried to outline earlier today. Secondly, and more importantly, inflation quite likely will stay at the present level or even accelerate as we get into the latter part of next year. As a result, what we do on the monetary side seems extremely important. That leads me to say that I would go to alternative II, which has a midpoint--what I [consider] the target--of 5 percent. Whatever we've said about ranges, they are unimportant to me except in how the public perceives them. I would hope whatever targets this Committee sets, whether on the long run or the short run, that the Desk at least in its month-to-month or day-to-day operations will look at the midpoints. So, I am looking at 5 percent for M-1A or 5-1/2 percent for M-1B. And I share Bob Mayo's view on going to M1 and doing away with M-1A and M-1B. I think they will confuse more than we will be able to explain.

CHAIRMAN VOLCKER. Mr. Timlen.

MR. TIMLEN. Mr. Chairman, I consider myself neither simple-minded nor complicated-minded, but just poorly educated for this forum. Having said that, I would have some preference on the technical side for the wider 3-point range shown. In terms of the aggregates to focus on, my preferences would be M-1A and M2. We have commented around the table about growth in bank credit and I do think the Desk should be asked to keep an eye on that number, which has looked so high the past year. My position is no different than it was last month. I look forward to having the yearly goals show a gradual reduction in the aggregates. I am most impressed by the comments Peter Sternlight made yesterday about inflationary expectations in the market. I think there will be a great focus on these goals as you announce them later this month; people will be looking for an indication of the posture of the Federal Reserve at this particular point in time. I might say, too, that as they look at our long-term goals, they will [do so with] the immediate impression of economic developments at the start of the year. January, I believe, will look strong. It may have an impact on the entire first quarter; people may not discount it, as Fred Schultz has suggested, as being all due to good weather. So, my preference is alternative III as stated in the Bluebook. And I would pick up the thought that Nancy Teeters noted earlier: That we will have opportunities to change the ranges at midyear in the event that some of the gloomy prospects do actually come to fruition. But I don't share the gloomy prospects personally.

CHAIRMAN VOLCKER. Governor Coldwell.

MR. COLDWELL. Mr. Chairman, it seems to me that we have been talking here about a series of figures which, quite frankly, I don't completely understand and in which I have a great lack of confidence.

The redefinitions seem to have added about 2 percentage points to these past figures. We are questioning the function; we are questioning the seasonals. I think the expectations have shifted on us. And if we are talking about supporting nominal GNP growth, I would observe that we had a 6.8 percent growth in M-1A last year and, if I read the correct line on this table, it supported an 11.3 percent increase in nominal GNP.

MR. PARTEE. With a 300 to 400 basis point increase in interest rates.

MR. COLDWELL. Yes, that's quite correct. In the coming year it looks to me as if we're talking about a GNP increase anywhere in the 8 to 10 percent range and maybe up to as high as 11 percent--that encompasses most of the forecasts I heard this morning--and making some progress in reducing the stimulation that both monetary and fiscal policy have added these past few years. I have to come out in favor of a much tighter monetary policy. And I would pick up on some people's comments in that I would hate to see another 6 percent increase in the monetary growth. So, I would put the target at 3 to 5 percent, centered on 4 percent with a 2-point spread.

CHAIRMAN VOLCKER. That's [alternative] III plus.

MR. BLACK. Is that for M-1A, Phil?

MR. COLDWELL. M-1A.

CHAIRMAN VOLCKER. Governor Teeters.

MS. TEETERS. Well, I am looking at where we want to be at the end of the year. I can't conceive of our ending up at 11 percent bill rates and a 7 to 8 percent unemployment rate. I would [be inclined toward] an M1 target of 5 percent, but that implies 11 percent on the T-bill and that's only a drop of one percentage point in that rate. So, I come out somewhere between alternatives I and II. I also think that our primary problem this year is going to be keeping above the minimum rather than going over the top of the monetary growth [ranges]. So, I would prefer alternative I but I could settle for alternative II.

CHAIRMAN VOLCKER. We're out of names.

MR. WINN. Paul, we have talked about the kind of minds we have. I think we can all claim to have confused minds. And it's clear that that's going to be the problem you face in your presentation. I would urge that we be sure to have the contrast between last year's targets and this year's targets on a similar basis so that people can understand whether the policy formulation is an increase or decrease or remains the same.

CHAIRMAN VOLCKER. I happen to agree with that. I am confused. Were we going to present the comparable figures on the old basis? Was that your intention, Mr. Axilrod, if I may interrupt?

MR. AXILROD. We hadn't intended to but we can.

CHAIRMAN VOLCKER. I missed that in the Bluebook.

MR. AXILROD. We presented them in an appendix in the Bluebook, giving the comparable figures to alternative II. That will be a decision for someone to [make]. That does run the risk of adding to the confusion, I might add.

CHAIRMAN VOLCKER. I understand. I think you have to leave that to us, but I personally have some sympathy for doing it this particular time and then maybe forgetting about it.

MR. WINN. Those would be the figures on the same basis? We won't present last year's on last year's basis and this year's on this year's basis--

CHAIRMAN VOLCKER. What I think we will do is present last year on last year's basis and on this year's basis. The question is whether to present this year's target on this year's basis and on last year's basis, [showing] what the equivalent target is.

MR. WINN. It seems to me that we have to get this into perspective.

CHAIRMAN VOLCKER. There's no difference for M-1A.

MR. PARTEE. It sounds complicated, but it's just two columns.

CHAIRMAN VOLCKER. Yes, that's right. There's no difference for M-1A. That's the same as the old M1, as I recall, for the year as a whole.

MR. WINN. I have a tendency to want to eliminate the confusion [caused] by too many numbers. We only add to the confusion. So, I would be inclined to use M-1B at the moment as being the most meaningful, although I share Henry's feeling that it's not a very good measure still in terms of--

CHAIRMAN VOLCKER. If I could just interject a comment: I understand the longing for simplicity, but I am afraid the reality is complicated. And M-1B is the figure that is going to be most thrown off by the uncertainty about NOW accounts. It is just a fact of life.

MR. BALLES. Mr. Chairman, just as a response to that: I assume from the Bluebook, Steve, that these different alternatives were set forth on the assumption that we would not get nationwide NOW accounts.

CHAIRMAN VOLCKER. That's right, at this point.

MR. BALLES. If we do get them, we'll obviously have to go back to the drawing board.

CHAIRMAN VOLCKER. Well, we'd have to make an estimate, and the estimate that is likely to be most different is for M-1B.

MS. TEETERS. I think you should emphasize in the press briefing that we are quite possibly going to have to change the specifications.

CHAIRMAN VOLCKER. Yes, we'd have to change the targets, not the definitions. You see, the danger is that we could get a big transfer from savings accounts into M-1B, and that's going to make that figure look very peculiar. And we won't know it in advance.

MR. WINN. I think the admonition that we are not casting these in concrete forever is a very important one at this stage. We have a chance to look at these again based on [unintelligible]. The inflation problem still dominates the public's attitude both toward our policy and what we are trying to achieve, and I would certainly want those numbers to look lower than last year's in terms of how they are set up. I think I'd probably come out with alternative III.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I favor alternative II with a range of 3 percentage points. Given the outlook for inflation over the next year, I think we're really going to have to show some reduction in the rate of growth in the aggregates. While I agree with Governor Partee that we want to be mindful of the amount of tension that we create in the economy with respect to what we expect on nominal GNP growth, on the other hand I also agree with Governor Wallich that we want to look at this point at M2 with regard to the provision for nominal GNP. That brings me to alternative II, with the range remaining at the wider 3-point spread.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, last month I argued for alternative III, but on further reflection that seems a bit too tight, so I would move to alternative II. I would keep the 3-point range, however, because I think it is important for our credibility that we end up with a result that's within the range. I think the experience of the last few months may have led us to believe that we can control the money supply much more finely than in fact is going to be the case. We have been very lucky, you know, in the last few months. In this last month all of the misses in our estimates offset each other nicely; that is, the deposit mix estimates were offset by the excess reserve estimate. Furthermore, even though we came in low on M1, we solved that problem by revising the seasonals. We're going to run into times when we find we are not going to be able to control the money supply quite as readily; and if we move to a very narrow range, we may regret it.

CHAIRMAN VOLCKER. Mr. Schultz.

MR. SCHULTZ. Well, I am not opposed to some degree of confusion. Last meeting it seems to me that we had a pretty hard time being very precise about these things. At the last meeting, I made mention of Heisenberg's theory of uncertainty, which in physics is a theory that when you try to observe sub-atomic particles the act of observation changes the way they act so you never know exactly where they are. I think that some of the same principles apply here and it seems to me that we should not try to be too precise at this point in time. These numbers are going to be revised. That's clear. Some time during the year, for some reason, we're going to have to engage in some revision. So, I would agree with Mr. Winn that there is some considerable impact in terms of [reactions to] the numbers we announce and I would come down on alternative III.

CHAIRMAN VOLCKER. Mr. Baughman.

MR. BAUGHMAN. Mr. Chairman, I am inclined pretty much along the line on which Bob Black started this discussion in that narrower ranges would seem desirable. And if we take a narrower range, then it seems to me that alternative II is appropriate. If we retain the wide range as stated in the Bluebook, which I am characterizing as wide, then I would be inclined to alternative III so as to get the ceilings down a bit. I am impressed also with Governor Wallich's comments. In fact, I have been inclined to postulate that the pace at which money substitutes or near monies are developed is quite possibly a function of the degree of restraint that we are attempting to impose upon the system. Consequently, the system may have substantial leakage or, alternatively, substantial elasticity. And that would tend to argue in favor of moving to pretty low numbers for the growth rates of the items reported here. I rather expect that is what we will experience as we move through the next two or three years and that we will have to move to growth rates in these conventional measures well below any that are currently contemplated if, in fact, we are going to make much impact on inflation. In presenting your views, I would think you are going to have to say something about 1981 as well as 1980. And it seems to me some rationalization along that line may be required in terms of fitting the growth rate numbers projected for 1980 with the idea that we need to have an annual reduction in the growth rate numbers until we do get to a non-inflationary environment.

CHAIRMAN VOLCKER. Mr. Roos.

MR. ROOS. Mr. Chairman, I am a little at a loss to understand why some of our colleagues, who I know are much more economically sophisticated and learned than I am, express confusion and concern as to whether or not we have a fundamental policy mandate and whether or not we can accomplish that. If one looks at this in a simplistic fashion, [one thing is] certain: We have told the world that our primary objective is a reduction in inflation accomplished on a gradual basis so as to avoid, if possible, drastic recessionary consequences. And we have said we're going to accomplish that objective by gradually reducing the rate of growth of the monetary aggregates. It seems to me that there has been overwhelming approval, both in the press and the public, and very little expression of disapproval of this basic policy objective. To me the biggest problem facing us, as I hear from people in our community, is a broad doubt or skepticism as to our willingness or ability to accomplish these objectives. I vehemently disagree with those of you who say that it is questionable whether or not we can gradually reduce the growth of the monetary aggregates. We can do it. We can do it either by controlling the path of total reserves or controlling the monetary base or a combination of both. I am a little concerned about the fact that we don't spend more time reflecting on what the monetary base and nonborrowed reserves and total reserves have done, as described on page 2 [of the Bluebook], because these are specific ways whereby we can accomplish our monetary aggregate growth [objectives]. In order to do what we've said we're going to do, we have to strive for a 5 or 5-1/2 percent rate of growth in M-1A or M-1B over the next year. I don't think we can react to short-term shortfalls or overruns on these [aggregates]. Anybody who says what has happened in the last two or three weeks is a cause for alarm just doesn't understand how this process works. We have to set long-term targets and we have to stick with those long-term targets unless and until there are fundamental changes in public thinking and fundamental changes in our policy that would [point] toward our retreating from these longer-term targets.

I would agree with Mark and others that it would be preferable, if we could possibly swallow this enormous step, to narrow our ranges so that we indeed can accomplish a 5 or 5-1/2 percent growth. I don't think it's our job to try to position ourselves so that our targets are so broad that we can always say we accomplished our targets if the world [falls apart] while we're protecting our own reputations. Our reputation is on the line. People totally and broadly subscribe to what the Chairman has announced and I don't think we can enjoy the luxury anymore of vacillating. The fat is in the fire and I think a narrow range under either alternative II or III around 5 percent for the M-1A and M-1B targets would be the best way to accomplish this.

CHAIRMAN VOLCKER. There's obviously a majority for retaining a 3-point range, as there was last month. I would defend that in my own mind by the uncertainty of the figures that Frank Morris and others have referred to and the real uncertainty in the economy, which goes in the direction of [our needing] a little leeway. I would note in that regard that I don't know of another central bank in the world, however monetarist oriented, that has a narrower target than 3 percentage points.

MR. PARTEE. The Bank of England?

CHAIRMAN VOLCKER. No. They have a 5 percentage point range, as I recall, 4 or 5. Four, I guess.

MR. TRUMAN. The Swiss have just a point or two.

MR. BLACK. And a pretty good inflation record.

MR. WALLICH. But [their target] varies with the rate of inflation.

CHAIRMAN VOLCKER. Do the Swiss have a pretty good record? They had something like a 15 percent increase in the money supply in some recent year, and they abandoned the target.

MR. WALLICH. I mean the range has to be seen relative to the rate of inflation. At 10 percent inflation, 3 percent [growth in money] isn't much. At 2 percent [inflation] it would be a great deal.

MR. SCHULTZ. I think we can get off this subject.

MR. ROOS. The Swiss did that on a contrived basis, though, to make their goods more competitive. It wasn't because the mechanism is not workable.

CHAIRMAN VOLCKER. Be that as it may, the greatest single view is for alternative III. There is a certain amount of clustering at alternative II, and one for alternative I. And there are some in between alternatives II and III and between II and I. One possible approach would be to adopt the Balles approach, which he justified in part in terms of the desirability of getting all the upper limits no higher than the growth we had last year. He [suggested] a combination between alternatives II and III, using the alternative II ranges on the M1s and something like the ranges in alternative III on M2 and M3, if I understood him correctly. I assume the staff judgment as to the internal consistencies of these ranges is not so precise that that becomes an impossible [combination].

MR. AXILROD. No, it doesn't become impossible, Mr. Chairman. But I remember last year that the old M2 ran above the projection, and that is the aggregate the Committee has come closest to cutting down to just about the lowest that is economically sustainable. I would just add that point. I think we gave very low, or conservative, estimates for M2. So there is some danger in it.

MR. PARTEE. Remember, you have money--

CHAIRMAN VOLCKER. Which way is the risk more? If interest rates decline, do you think M2 would balloon or not?

MR. AXILROD. Well, in the old days, I would have said it would have ballooned. Nowadays, with interest rates so far above ceiling rates, we don't have that effect. We have put the money market funds into M2 and there is going to be a lot of substitutability between the money market funds and other elements of M2. The risk is for higher growth if interest rates decline, but I don't think it is nearly as great a risk as it used to be.

MR. PARTEE. I might just point out that M2 [growth in 1979] was very close to the upper limit on alternative II, John, and for M3 [actual growth] was the same as the upper limit on alternative II. The aggregate that is really low is bank credit. I don't quite understand that.

CHAIRMAN VOLCKER. Well, these are in my judgment very narrow differences. Let me just try, after everybody has listened to all of this, two alternatives: alternative III straight and alternative II straight. I might say it didn't make much difference in clarifying any strong preference to add the views of nonvoting members onto those of the members; they're split in about the same way. So just for the voting members, after hearing each other, how many would want alternative III?

MR. BALLES. Mr. Chairman, this will just be--

CHAIRMAN VOLCKER. I am just talking about a flat "III."

MR. BALLES. Really, between the one or the other--

CHAIRMAN VOLCKER. Now let me try "II." Who would find alternative II "acceptable"? Four. Let me try the Balles alternative and see how many would find that acceptable.

SPEAKER(?). Read it.

CHAIRMAN VOLCKER. It's alternative II for M-1A and M-1B, if I understand it correctly, and alternative III for M2 and M3. Maybe that would be the nicest, if we could achieve a consensus on that.

MR. PARTEE. What about bank credit? Is that alternative III?

CHAIRMAN VOLCKER. I've been implicitly assuming that bank credit takes a subsidiary role in this as it indeed has in the past.

MR. PARTEE. It is, of course, one of the figures.

CHAIRMAN VOLCKER. One could argue about that, I suppose.

MR. COLDWELL. It's so violently different from [the actual experience in] 1978 and 1979.

MR. SCHULTZ. I would like to have somebody explain the Balles approach to me. I find Steve's comments important here. Why shouldn't it be alternative III on M-1A and M-1B and alternative II on M2 and M3? That would seem to me more consistent with what actually happens in the economy. Am I looking at it the wrong way?

MR. BLACK. I would prefer that.

MR. PARTEE. John wants the top of the range below last year's [actual].

MR. BALLES. I want the top of the range at least moderately below.

MR. SCHULTZ. I understand what he proposed. He's just taking a somewhat mechanistic approach. But I am thinking of what actually happens in the economy. It seems to me that if we're going to go away from alternative III, which is the alternative I continue to prefer, where we should ease is in M2 and M3 rather than the other way around. Is that the wrong way to look at it?

CHAIRMAN VOLCKER. Well, that seems to be a bit in line with Mr. Axilrod's suspicions, for whatever that's worth. On the other hand, it doesn't achieve Mr. Balles's visual purpose.

MR. SCHULTZ. I don't understand that there's any particular reason to ease on M-1A and M-1B because I have some real questions about velocity. But if Mr. Axilrod is right, the figures on M2 and M3 are likely to be more stringent than those on M-1A and M-1B.

MS. TEETERS. Do you all realize that alternative III means essentially no decline in interest rates this year?

CHAIRMAN VOLCKER. That's what the staff says. I have a little uncertainty about what that figure--

MR. RICE. Is that a proposal, Mr. Chairman?

CHAIRMAN VOLCKER. Well, I can't have too many proposals on the table at the same time. I don't know whether Mr. Balles wants to retreat to Mr. Schultz. I am willing to try your original one and just see [what support it commands].

MR. BALLES. I would be interested in the vote on my proposal. I didn't see a show of hands yet.

CHAIRMAN VOLCKER. What we're talking about now is what is acceptable to the biggest group we can get, I think. I can try the Schultz alternative, too, to confuse the issue further, but let me try the Balles alternative at this stage.

MR. COLDWELL. You got 3-1/2 votes.

CHAIRMAN VOLCKER. Well, let's try the Schultz alternative. This is exactly the opposite. Alternative III on M-1A and M-1B and alternative II and M2 and M3.

MR. BLACK. This just means acceptable, not necessarily preferable?

CHAIRMAN VOLCKER. This means acceptable. That is precisely right. Are we really saying nothing is acceptable here?

MR. SCHULTZ. Well, I got more than he did!

SPEAKER(?). No, you didn't.

MR. SCHULTZ. I got 5 votes.

CHAIRMAN VOLCKER. The only thing I am convinced of is that we are in a range where the differences are very difficult to perceive.

MR. BLACK. It's [as if we] perceive more [differences] than there really are.

MR. GUFFEY. You had 8 for alternative III, Mr. Chairman.

MR. BLACK. You sure did. And that was a preference, not just acceptable.

CHAIRMAN VOLCKER. Well, I am a little reluctant to go to alternative III. It is clear that that has a plurality, but whether it is the one that maximizes the satisfaction around the table is another question.

MR. PARTEE. Well, I can't really offer a compromise since I was for alternative I.

MR. SCHULTZ. You were the only one. Maybe you're the only one who can offer a compromise.

MR. COLDWELL. We can't possibly get close.

CHAIRMAN VOLCKER. Just looking at what maximizes satisfaction for all, I urge again the Balles approach with a more sympathetic attitude by people around the table.

MR. PARTEE. Maybe somehow it will work out.

MR. TIMLEN. Is there any understanding as to where in the range the Desk would be shooting for?

CHAIRMAN VOLCKER. Well, theoretically, we are shooting for the midpoint, based on what we know now. We may modify that in the short-run decision; we haven't gotten there. But for the year as a whole the implication is that the best judgment we can make is that we're shooting at the middle of all of these, which gives us some leeway on [M2 and M3] presumably, if we're really shooting at the middle of the [target for M1].

MR. BALLES. My presumption, Mr. Chairman, is that of course we would aim for the midpoint, but I would also very quickly add that in view of all the uncertainty we would want to be able to move either way, including to the top of the range. I think we ought to keep that flexibility.

CHAIRMAN VOLCKER. I would agree with that. But as of now I think we are saying the central tendency is the midpoints of these ranges, which gives us some potential leeway in deliberately moving away from the midpoint and also gives us some leeway in the reconciliation among these various numbers. I suppose the implication of that, to sell [this] alternative now, is that if we were literally aiming for the midpoints throughout the year and M2 and M3 prove to be a little tight relative to the M1s, we would end up with a slightly lower M1 and a slightly higher M2 and M3, relative to the midpoints. If the staff estimate is correct and everything went perfectly, that's presumably the way [it would turn out]. We would end up with the midpoint, theoretically, halfway between alternative II and alternative III.

MR. AXILROD. Mr. Chairman, if the Committee is willing to accept a range of 2-1/2 points, an almost perfect compromise is to take the bottoms of alternative II and the tops of alternative III.

MR. BLACK. That's not a bad idea.

MR. SCHULTZ. I'd feel more comfortable with that than with the Balles approach.

CHAIRMAN VOLCKER. Did you say leave these where they are?

MR. ALTMANN. 3-1/2 to 6 percent.

CHAIRMAN VOLCKER. You're narrowing all the ranges.

MR. ALTMANN. The bottoms are from alternative II and the tops are those in alternative III.

MR. BALLES. That runs counter to a clear majority view about keeping a wide range.

MR. MAYO. Yes, it does.

MR. BLACK. But it appeases some of the rest of us.

MR. PARTEE. That results in odd midpoints.

CHAIRMAN VOLCKER. You obviously know [the area we're in]. I really am resistant to getting down to 1/4 points. If what we're aiming at for M-1A is halfway between [the midpoints of] alternatives II and III, [that difference is] 1/4 of a percentage point and I think we're really there with the Balles approach as a practical matter.

MR. SCHULTZ. Are we not likely, though, to end up with a situation in which we're going to miss on both sides with the Balles approach? M2 and M3 may be strong and M-1A and M-1B could be pretty weak.

CHAIRMAN VOLCKER. Presumably these are the best estimates we have. I will not vouch for the inter-relationships between them. [They represent] an unbiased estimate of the consistent--

MR. AXILROD. We rounded these to 1/2 points, by the way. For M2 and M3 I think the [actual] differences are 1/4 points among the alternatives.

CHAIRMAN VOLCKER. We're now unrounding them. Let me urge upon you at this point the Balles alternative. How many find that acceptable after this further [discussion]?

MR. SCHULTZ. To show you how weak I am, I'll vote for it. As I do so, I am being dragged kicking and screaming into this. I would much prefer the other.

MR. BALLES. How many was that, sir?

SPEAKER(?). Six.

CHAIRMAN VOLCKER. If I [add my vote], it's a majority. But I can't believe that when we get down to a 1/4 point there is no combination of numbers that does not provide a happier situation.

MR. TIMLEN. Could you try Steve's range, because its width is 2-1/2 points as opposed to 3?

MR. ALTMANN. And not emphasize midpoints?

CHAIRMAN VOLCKER. But there's no substantive difference between them.

MR. BLACK. But it's the way it is perceived.

SPEAKER(?). It is the way it is perceived by the public, Paul, that's important. I agree there isn't all that much difference but the perception by the public--

SPEAKER(?). It's the top of the ranges that scares me to death.

MR. COLDWELL. We could widen the range to 3 to 6-1/2.

CHAIRMAN VOLCKER. Well, I don't think we want to go in the direction of widening the range. There are all sorts of ways we can get a quarter peoint difference between the averages.

MR. WILLES. But the problem, Mr. Chairman, is not the quarter point difference on the midpoint. Where people separate is on where they think the bottom ought to be or where the top ought to be. And that's why Steve's proposal, I think, will get most of the votes. It's not the quarter point difference; it's where one is willing to let it go on one side or the other.

MR. BLACK. I think that's a correct appraisal. I think the market will look at it that way, too.

MR. PARTEE. We have a tremendous amount riding on our ability to be within these ranges--

SEVERAL. Yes.

MR. PARTEE. --and to cut the range to 2-1/2 points makes it rough. And the possibility of inconsistencies here, even though we are within the staff's ranges--

CHAIRMAN VOLCKER. What are we talking about specifically?

MR. ALTMANN. 3-1/2 to 6 percent.

MR. MAYO. Why don't we just see what the vote is, Mr. Chairman, on the bottom of alternative III and the top of alternative II, widening the range by 1/2 percentage point.

MR. COLDWELL. That's what I suggested, but he--

MR. MAYO. It has some merit.

MS. TEETERS. If we want to compromise, we should go to 3-1/4 to 6-1/4 percent.

CHAIRMAN VOLCKER. That's the straightforward compromise, but I think we look foolish if we get into quarter points.

MR. PARTEE. We would bill the 3-1/2 percent [as appropriate] on the grounds of the great uncertainty in the year ahead.

MR. WALLICH. We could accept Steve's [suggestion] as long as we don't focus on the midpoint. The midpoint gives us a quarter point and looks foolish. A narrower range, other things equal, looks better. I see the risks; we might miss. We're much more likely to miss on the up side than on the down side.

MR. PARTEE. What I foresee is the possibility of misses if the relationships aren't right here. We may be within on M1 and out on M2 and M3.

CHAIRMAN VOLCKER. If we do it the other way, we have a better chance of being within something.

MR. WILLES. But that's precisely why people care so much about either the bottom or the top. Even though we may miss, if we're going over the top, that raises the flag a lot faster than if we're still within all the ranges.

MS. TEETERS. I have noticed that people worry less when we go under than when we go over.

MR. MAYO. It depends on one's point of view.

MR. WINN. Well, I'll go back to my original question. What are you going to say about last year's ranges?

CHAIRMAN VOLCKER. About last year's ranges?

MR. WINN. People are going to compare ranges and ranges, not--

CHAIRMAN VOLCKER. Well, what we're going to tell them is that on M1, depending upon how you look at it, we were somewhere around 5.5 or 6.8 percent.

MR. WINN. That's what we hit, but [the question is]: Are we setting our objectives lower or higher?

CHAIRMAN VOLCKER. All of these objectives, properly interpreted, will be lower. It may take some interpretation.

MR. WINN. But didn't we say 3 to 6 percent last year on M1? Sure it has changed, and so forth--

CHAIRMAN VOLCKER. Well, we said 4-1/2 to 7-1/2 percent by one interpretation, with 1-1/2 percent ATS--

MR. BLACK. That's really what it was, when you come right down to it.

CHAIRMAN VOLCKER. Well, I don't like this way of skinning the cat, but do you want to do these 2-1/2 percentage point ranges? Let's see who finds the 3-1/2--

MR. MAYO. What are we talking about? The 2-1/2 points?

CHAIRMAN VOLCKER. Yes.

SPEAKER(?). John, I assume you'll go with this proposal.

CHAIRMAN VOLCKER. Well, we get no more votes for that one than the other one.

MR. SCHULTZ. Straight alternative III got the most votes.

CHAIRMAN VOLCKER. No, I don't think so.

MR. WILLES. Take an acceptable vote on alternative III; I think you'll get 9 out of 12.

MR. HOLMES. Mr. Chairman, another compromise would be to take a flexible midpoint. Take the [average of the] midpoints from alternatives II and III and say you expect variations around that of 1-1/2 percentage points on either side, as we have in the past.

MR. BLACK. That would be 3-3/4 to [6-3/4 for M-1B].

MR. SCHULTZ. It gets us to quarters.

MR. COLDWELL. Would it help, Mr Chairman, if we used M-1B as opposed to M-1A as the starting point?

CHAIRMAN VOLCKER. Well, the figures are supposed to be the same. I don't know how to--

MS. TEETERS. Yes, but M-1B has the most potential for fluctuation.

MR. COLDWELL. But M-1B has the most long-run potential. M-1A, if you read it as "MIA," is "missing in action."

MR. BLACK. M-1B is "misinformed bunch."

CHAIRMAN VOLCKER. It seems to me that the logical thing, without getting into tiny fractions, is either to do the Balles approach or the reverse of the Balles approach, which is about as much of a compromise as one can get, retaining the wider ranges. Now, that avoids quarter percents on either the midpoints or the outside [limits of the] ranges. Who do we have reconsidering? Or who wants to make another proposal?

MR. MAYO. In the interest of simplicity, I am prepared to shift my vote to alternative III.

CHAIRMAN VOLCKER. The trouble with alternative III--frankly, I have no particular problem with it--is that it's going to make some people more unhappy than any of the other alternatives.

MR. MORRIS. But only 1/2 of 1 percent were unhappy!

MR. MAYO. There's a multiplier here, Paul.

MR. RICE. Let me put it this way: It makes me unhappy but in the spirit of unanimity I would change my vote and go with alternative III.

MS. TEETERS. It's a full percentage point drop in the growth rates from last year. Doesn't it mean that we're going to have an increase of 2 percentage points in the unemployment rate and no change in interest rates?

MR. PARTEE. That's probably right.

MS. TEETERS. Where are interest rates in [that scenario]?

MR. RICE. Well, I surely share [that concern] with you.

MS. TEETERS. Even taking all the probabilities in the staff estimate, the likely rate of [GNP] growth is between .8 and -2.2 percent. That is just not a very good economy, gentlemen, to have 12 percent interest rates.

MR. WALLICH. But, Nancy, on the other hand, we'd get a rise in the rate of inflation.

MS. TEETERS. We're going to get that anyway, Henry, from OPEC over the first three months of this year.

MR. COLDWELL. If we're going to get it anyway, you better be down where I am.

MR. SCHULTZ. Actually, alternative III, you have to remember, is much more lenient than where Governor Coldwell would like to be. So that--

MR. KIMBREL. Associate me with that, too.

MR. PARTEE. Of course, he won't be here to--

MR. COLDWELL. No, I am going to be out in the ranks of the unemployed with fixed incomes to pay the price--

CHAIRMAN VOLCKER. Well, I would recommend to you the Balles position. But if you're bound and determined to go to alternative III, we'll go to alternative III. Let's try Balles once more.

SPEAKER(?). I'm not going to vote for it this time.

MR. SCHULTZ. Things are coming my way!

CHAIRMAN VOLCKER. How many did you get? What was the count?

MR. ALTMANN. Five.

MR. PARTEE & MR. TIMLEN. Five; we've lost one!

MR. BALLES. Well, I tried, Mr. Chairman.

MR. BLACK. That's the end of Balles, et al.

MR. MAYO. The "et als" are still around.

MR. BALLES. My next move would be to alternative III.

CHAIRMAN VOLCKER. With great reluctance, I will try "III."

MR. ALTMANN. Nine, Mr. Chairman.

CHAIRMAN VOLCKER. It is a mistake.

MR. COLDWELL. Why, Paul? What's your principal reservation about it?

CHAIRMAN VOLCKER. My reservation is not the substance of it, but that I don't think it correctly gets to the midpoint of the range of opinion.

MR. COLDWELL. Well, go back and try the Schultz approach again. That looks to me as if it buys a good share of those of us who are concerned about--

CHAIRMAN VOLCKER. By the Schultz approach you mean just reversing--

MR. COLDWELL. Reversing the Balles points.

CHAIRMAN VOLCKER. Oh, I am perfectly happy to do that. Let's try that one.

MR. COLDWELL. Take M-1A and M-1B of "III" and M2 and M3 of "II."

CHAIRMAN VOLCKER. Let's see whether that captures--

MR. ALTMANN. Seven.

MR. BLACK. Seven? Doesn't it make you two even a little happier?

MS. TEETERS. A 4-1/2 percent rate of growth for M1? No.

MR. COLDWELL. Well, if that's the case, we better stay with alternative III.

CHAIRMAN VOLCKER. I think everyone is stuck on III; that's okay.

MR. ALTMANN. So, it's alternative III?

MR. TIMLEN. How would the chair vote?

CHAIRMAN VOLCKER. Yes.

SPEAKER(?). You would vote for it?

CHAIRMAN VOLCKER. Well, I'll vote for alternative III if that's what everybody wants to vote for. I don't see the significance in the 1/2 percentage point difference that some other people apparently see.

MR. PARTEE. Well, I don't either, but it takes me a whole point [lower].

CHAIRMAN VOLCKER. Oh, I understand.

MR. AXILROD. Mr. Chairman, is the staff to assume that in making its GNP projections, it should take the 4-1/2 percent rate of growth for M-1A as a center point? That is a lower rate of growth than we had.

CHAIRMAN VOLCKER. I presume that in some sense that must be the implication.

MS. TEETERS. You realize we're already in trouble in terms of being in conformity with the Administration's forecast. At least you have to do the testifying on Humphrey-Hawkins. We're already inconsistent; this is making it worse.

MR. COLDWELL. The President has given up on Humphrey-Hawkins for this coming year anyway. He moved out [the time period in which to reach the objectives].

MS. TEETERS. He may have moved it out but the Administration's forecast is markedly different. And we will have to go up to the Hill and say we're going to keep money so tight that there is no way that the Administration's forecast can be realized. That's about what it comes down to.

MR. SCHULTZ. I am really much more concerned about M2 and M3 than I am M-1A or M-1B because at these interest rates and these inflation rates I am very unsure of the connection between the two. And I think there is going to be a demand shift this year. The staff indicates that they can see no indication yet, but--

MR. PARTEE. [It can] hardly be bigger than it was last year. We already had a great big demand shift in the recorded figures for last year. For M-1B, which I think a lot of people would support as the better redefined money, our midpoint will be 3 points below what we realized last year. Three points!

CHAIRMAN VOLCKER. Well, that figure is a little artificial because we had the shift into ATS and NOW accounts.

MR. BALLES. This is a question of fact, Mr. Chairman. What impressions do you have as to whether the Congressional Committee considers the ranges as having a very strong implication that we'll move toward the midpoint? I haven't gathered that that was true in the past; we have ranges with the precise idea of being flexible. In-house we may well aim for a midpoint. But in terms of the Congress, is my impression wrong that they look on these as ranges we feel free to utilize fully depending on unfolding conditions?

CHAIRMAN VOLCKER. I can't answer that question. It probably implies a degree of sophistication on the part of Congress that is beyond any generalization.

MR. BALLES. There seems to be a feeling around the table here that if we adopt alternative III, we're struck with the midpoints. I don't think we are, frankly.

MS. TEETERS. What else is the Desk going to aim for?

MR. BALLES. What's the purpose of having the range?

CHAIRMAN VOLCKER. We'd certainly have a tendency right now to aim for the midpoint, not knowing anything else. That's pending further information.

MR. MAYO. That is true in the short run, Paul, but as the year moves on, we have that flexibility. We just finished using it the last time.

CHAIRMAN VOLCKER. Yes, in the short run.

SPEAKER(?). We sure did.

MR. AXILROD. Mr. Chairman, I don't know if this will be helpful, but one possibility--in the spirit of what has been discussed --is to take the 3-point ranges for M-1A and M-1B of alternative II and to lower the top ends of M2 and M3 by 1/2 point.

CHAIRMAN VOLCKER. Well, I was going to suggest the opposite. If there's more of a concern about M2 and M3, maybe we should take a 1/2 percentage point off the top of the M1 ranges.

MR. AXILROD. Then you have more substitutability among the deposits?

CHAIRMAN VOLCKER. And it leaves us a little more leeway on M2 and M3.

MR. PARTEE. I'd go for that.

CHAIRMAN VOLCKER. Presumably they are, theoretically, a little more volatile anyway.

MR. COLDWELL. 2-1/2 to 5-1/2 percent on M-1A?

SPEAKER(?). No.

CHAIRMAN VOLCKER. [For M-1A] 3-1/2 to 6 percent--a compromise between alternatives II and III on both the M1s.

MR. SCHULTZ. All right. I'd go for that.

MR. ALTMANN. And 4 to 6-1/2--

CHAIRMAN VOLCKER. It's 4 to 6-1/2 percent on M-1B, which is probably going to have to be revised anyway.

MR. PARTEE. I'd be happy.

CHAIRMAN VOLCKER. And leave the 6 to 9 percent and 6-1/2 to 9-1/2 percent [for M2 and M3, respectively].

MR. BALLES. What was M-1A, please?

MR. ALTMANN. 3-1/2 to 6 percent. And M-1B is 4 to 6-1/2.

MR. COLDWELL. What about M2 and M3?

CHAIRMAN VOLCKER. They're the same as in alternative II.

SPEAKER(?). There's something wrong.

CHAIRMAN VOLCKER. There's a bit of logic in it, I think.

MR. SCHULTZ. That's logical, and I like that.

MR. BALLES. Just a comment on that, Mr. Chairman: The reason I was turned off by alternative II for M2 and M3 is that if we went for the upper end of that range, which I presume we could, that would result in no decrease at all in the growth rates of those two magnitudes for 1980 from what we experienced in 1979.

MR. PARTEE. If we go right to the top.

SPEAKER(?). We also have to recognize that they're rather uncontrollable by us with money market funds and Eurodollars and Caribbean dollars and RPs in there.

CHAIRMAN VOLCKER. We lose that visual effect, but it's getting argued that the economics are a little against us in terms of the uncertainty and it gives wider ranges. I think there's a certain sense in doing that. It has the disadvantage that--

MR. COLDWELL. So the midpoint on M-1A would be 4-3/4 percent?

CHAIRMAN VOLCKER. That's right. [Unintelligible] mislead with that quarter percent.

MR. WALLICH. That's just raising it, on average, because the lower ends don't really mean anything.

MR. PARTEE. Well, they could.

CHAIRMAN VOLCKER. It's raising depending upon where we begin.

MR. WALLICH. Well, it seems that we'd very likely do something if it came out there. Even I would be prepared to do that.

CHAIRMAN VOLCKER. You say raising on average. Depending on what one is looking at, it's accepting the upper constraint of alternative III on M1. That's the one you're worried about.

MR. WALLICH. Well, I was more worried about M2, and there we have an increase. Raising the lower constraints on M-1A and M-1B doesn't really accomplish anything.

CHAIRMAN VOLCKER. Well, let's try this one. I appeal to you: Anyone around this table who is good enough to know the difference between 1/2 point, with great [conviction], is pretty good.

MR. TIMLEN. Is that for simple or complicated minds?

CHAIRMAN VOLCKER. Does it have any appeal?

MR. SCHULTZ. I'd vote for it.

MS. TEETERS. Want another straw vote?

MR. KIMBREL. Just to be sure I am with you, read those numbers one more time.

CHAIRMAN VOLCKER. They are: 3-1/2 to 6 on M-1A; 4 to 6-1/2 on M-1B; 6 to 9 on M2; and 6-1/2 to 9-1/2 on M3. Who finds that acceptable?

SPEAKER(?). Here we go!

MR. ALTMANN. Eight.

CHAIRMAN VOLCKER. And I make nine.

MR. COLDWELL. What did we finally get on the vote for straight alternative III?

CHAIRMAN VOLCKER. I think about the same.

MR. ALTMANN. I had seven, not counting--

CHAIRMAN VOLCKER. Seven, not counting me. So we got one more vote out of this one, right? Let's go with that one then. All the people who like narrow ranges ought to be enchanted by that 1/2 percent [reduction in the ranges for M-1A and M-1B].

MR. PARTEE. The narrower M1 range.

MR. GUFFEY. Which one did you go with, the last one?

SPEAKER(?). Yes.

MR. GUFFEY. I thought we had more votes for alternative III.

MR. TIMLEN. I thought so, too.

SPEAKER(?). Try again.

MR. ALTMANN. No, I had seven not counting the Chairman. Want to try it again?

MR. BALLES. What was the vote on the last one, Murray?

MR. ALTMANN. Eight plus the Chairman.

MR. SCHULTZ. I think the Chairman is saying that we may have had more votes on that, but those who are the unhappiest would find this last one acceptable. Is that your reasoning, Mr. Chairman?

CHAIRMAN VOLCKER. I don't know quite what I will find at this point, frankly.

MR. SCHULTZ. I can go either way.

MR. RICE. In light of this vote, I'll shift from my last vote and make it even. I voted for alternative III in the spirit of compromise, but now that I know we can get 8 votes for this, which is more acceptable to me, I would like to switch my vote and make it [9].

SPEAKER(?). Let's have a vote on this compromise and see what we get.

MR. BLACK. Maybe I ought to reactivate my proposal?

CHAIRMAN VOLCKER. Let's take a vote on the latest proposal. Is everybody clear about what we are voting on?

MR. MAYO. The same thing that we just voted on.

MR. ALTMANN. That's right, the 3-1/2 to 6, 4 to 6-1/2, 6 to 9, and 6-1/2 to 9-1/2.

MR. BLACK. What about bank credit? Are we going to have to put that in?

CHAIRMAN VOLCKER. Bank credit, I guess, is 6 to 9 percent.

MR. ALTMANN. 6 to 9.

SPEAKER(?). What about M2?

MR. SCHULTZ. Henry thinks it's too high.

MR. PARTEE. If we expect to get it, we're going to have to raise marginal reserves.

MR. ALTMANN.

Chairman Volcker	Yes
President Balles	Yes
President Black	Yes
Governor Coldwell	Yes
President Kimbrel	It's mighty hard, but I vote yes, too.
President Mayo	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
First Vice President Timlen	Yes
Governor Wallich	In the spirit of compromise, yes

CHAIRMAN VOLCKER. Well, I appreciate your swallowing all these 1/2 percentage point differences! I think it's probably more important to swallow the 1/2 point differences than to achieve the 1/2 point.

MR. WALLICH. Well, can we swallow something real now?

CHAIRMAN VOLCKER. Yes. After all this time, we have a great decision. How much problem are we going to have with our even narrower differences on the short-run ranges? Do you want to try to do this [before lunch]?

SPEAKER(?). Yes.

MR. BLACK. Maybe we can just vote without any statement from anybody. It might be better.

MS. TEETERS. Yes.

CHAIRMAN VOLCKER. Let's see where we are without going around the table. Do you want to say a few words, Mr. Axilrod--very few?

MR. AXILROD. I will skip the introductory part, a page and a half, which says that interest rates aren't projected to come down as much as they used to be because the economy is projected to be stronger. [Secretary's note: For the full text of Mr. Axilrod's statement, see Appendix.]

CHAIRMAN VOLCKER. If I understand this precisely, your alternative B, at least for M1, reiterates the target we already set at the last meeting.

MR. AXILROD. Yes.

CHAIRMAN VOLCKER. And this can viewed as kind of a mid-quarter relook at that.

MR. AXILROD. That's right.

CHAIRMAN VOLCKER. But M2 is a little below, right?

MR. AXILROD. The [new] M2 is a totally different concept.

CHAIRMAN VOLCKER. We didn't set a target for that.

MR. AXILROD. That's right. It was the old M2--

CHAIRMAN VOLCKER. That target was 7 percent; that's what confused me.

MR. AXILROD. That's right. And it is in fact running a little low relative to the target.

CHAIRMAN VOLCKER. But you think this 6-1/2 percent that you have here for the new M2 is roughly consistent with the 7 percent that we had on the old M2?

MR. AXILROD. I would guess it's a shade lower because the old M2 is running a shade lower. It's either consistent or a shade lower. I haven't worked it out in detail month by month on money market funds.

MR. WALLICH. But it contains very different components.

MR. AXILROD. Oh yes, that's right. That's why. It has money market funds--

CHAIRMAN VOLCKER. But it has been running higher than 6-1/2 percent, apparently, because you have the implied growth for January to March of 5-3/4 percent.

MR. AXILROD. Yes. The actual growth in M2 is 8.3 percent because, among other reasons, we had this very sharp expansion in money market funds in January, which we've been expecting to slow.

CHAIRMAN VOLCKER. There's a question of procedure we have to decide upon, which is whether to reiterate or change the targets that we had for the first quarter. [We can comment on] any tentative feeling that we have about the second quarter but we don't have to put the second quarter into the directive, and I think it's probably inappropriate to put the second quarter in the directive at this point. So, if people agree with this, the only thing we have to have in the directive is a number for the first quarter.

MR. AXILROD. To be clear, Mr. Chairman, alternative B, as we construe it, is simply reiterating the Committee's policy of last time with respect to M1.

CHAIRMAN VOLCKER. Right.

MR. AXILROD. That's in new terms and takes account of the actual growth that occurred in January.

CHAIRMAN VOLCKER. And in both cases--just slightly in the case of M1 and a little more than slightly in the case of M2--the rate of growth in January was above our targets [for the quarter].

MR. AXILROD. Yes. But, again, this is a totally different M2.

CHAIRMAN VOLCKER. Yes, after we translate them.

MR. AXILROD. But the old M2 is running a little lower relative to target than we had expected.

CHAIRMAN VOLCKER. So if we take alternative B, conceivably we could shade it a bit in the light of our earlier discussion. But I think we're talking--

MR. PARTEE. I think what we'd shade is the second quarter. After all, the first quarter--

CHAIRMAN VOLCKER. Well, that would be my inclination. Looking at this in view of what we just decided, the second quarter figures may be a little high. But we don't have to decide upon that now. Otherwise, what you're saying is that "B" is basically reiterating what we said before, which does imply a little slower growth rate in February and March than we in fact had in January. That's because January was high in M2--and M1 came out a little bit on the high side, but not very much--because of the money market fund bulge. I would suggest to you, but I don't want to hasten you if there's some vital question that I am missing, that just for the first quarter "B" is reasonable. I think it's not only in line with what we decided last time, but what we want to continue to decide.

MR. MAYO. Are we content with a point target here? Is that the way we should read this?

CHAIRMAN VOLCKER. This is the central tendency, obviously. Last time we worded it 4 to 5 percent on M1. We could raise the question again of whether we want to continue with that wording. We said 4 to 5 percent on M1 and about 7 percent on M2. I suppose what we'd be saying here is that the Committee reiterated--if you want to word it that way--the 4 to 5 percent range on M1. And on the new M2 basis, we'd shave the target a half point.

MR. MAYO. There could be some argument, Paul, that we're farther along in the quarter and should narrow that range. Or we could say 4-3/4 percent, which is--

CHAIRMAN VOLCKER. Well, I don't feel strongly about that. Even on the new technique we're not that close. This is a pure matter of preference; we can word it either way. I don't have any--

MS. TEETERS. I would prefer to word it "4 to 5 percent."

MR. MORRIS. I think there's a lot to be said for stability from month to month in these directives, unless there's a major reason to change.

CHAIRMAN VOLCKER. Particularly if we keep that same wording, we'd be a little hard pressed to [rationalize] changing it by a quarter percentage point, which one could argue we might want to do on the basis of the long-term range, all else being equal. But that's such a fine adjustment. More substantively one could argue, given what's going on, that we might want to be tighter or easier.

MR. COLDWELL. I would argue for alternative C with a borrowing level of $1.6 billion.

MR. PARTEE. 1.6?

MR. COLDWELL. That is about what they had, $1.5 billion, for alternative C.

CHAIRMAN VOLCKER. I think "C" is clearly saying, given what we know now that we didn't know last time, that you want to be a little tighter.

MS. TEETERS. I think we should stick to where we were.

CHAIRMAN VOLCKER. "B" says that we want to play it about where we've been playing it; "A" says we distinctly want to be a little easier. I think those are the choices here.

SPEAKER(?). I'd keep "B."

MR. PARTEE. Yes, I think we ought to stay where we were until we go off in a big way, which we'll do soon.

MR. TIMLEN. While I prefer what Phil Coldwell said, I would vote for "B."

CHAIRMAN VOLCKER. Are there any other comments? I really don't want to rush this, but I think we ought to go to lunch if we don't have a consensus here. If there's a lot of argument that we should be distinctly tighter or if the differences are massive, [maybe we should break for lunch]. In fact if we took "C," I think we would have to raise the targeted level of borrowing. I don't know what is consistent, but I--

MR. COLDWELL. They have $1.5 billion in the Bluebook.

MR. WALLICH. The measure of tightness in the face of higher inflation is not the money supply. It is really the interest rate, or the real interest rate. I see that as having come down.

CHAIRMAN VOLCKER. It depends upon whether you're looking at the long-term or the short-term rates.

MR. WALLICH. It doesn't bother me to tighten the money supply, not because I think that's the proper response but because I think it will have the desired result.

MR. SCHULTZ. It will have a result all right. It will really knock housing and autos in the head!

CHAIRMAN VOLCKER. Willis.

MR. WINN. Paul, there's another question. Maybe this is not relevant, but in view of our unwillingness to come to terms with the lagged reserve question and in view of my nervousness with respect to our luck in holding out on this setup, is this perhaps the appropriate time to raise the question, given the fluctuations in borrowings and the growing differential between market rates and the discount rate, about changing the rate as part of this picture of [unintelligible]?

MR. SCHULTZ. You mean the discount rate?

MR. WINN. The discount rate.

CHAIRMAN VOLCKER. It's always a relevant policy variable. But to some degree there's a choice. We can be easier on the reserve provision and raise the discount rate. We can be tighter on the reserve provision and not raise the discount rate.

MR. WINN. But the danger is that we will lose control in the latter case.

MR. WALLICH. I think we should be clear on what overall response we want and to me that is expressed in the funds rate.

MR. COLDWELL. I think we have a chance here to make a nibble into that long-term range; and if we give that up now, we may not have a chance later on.

CHAIRMAN VOLCKER. Well, the funds rate is theoretically not predictable under what we're doing. But if we go toward "C," we are biasing it, presumably--

MR. COLDWELL. On the upper part of the range.

CHAIRMAN VOLCKER. --on the upper part or for an increase from where we are. Not knowing anything else, I don't know what would actually happen. But presumably we would push the level of borrowings up a bit, which might or might not push the funds rate up. In "B," we would not push the borrowings up, which might or might not be accompanied by stability in the funds rate.

MR. AXILROD. Initially.

CHAIRMAN VOLCKER. Initially. And it's all going to be looked at--. The last money supply figures we have are weak, right?

MR. AXILROD. I am a little hesitant because I haven't seen the last [figures] on the new basis. On the old basis they were weak, but I haven't seen the new ones on the new weekly seasonal pattern yet. The old figures were weak, but we had expected a considerable rebound.

MR. STERNLIGHT. [Unintelligible] foreign deposits.

CHAIRMAN VOLCKER. Well, I don't know how to [interpret] the silence of most people. But Governor Coldwell has expressed himself for wanting to tighten up a little here.

MS. TEETERS. I would prefer alternative B.

MR. PARTEE. It seems to me that we might very well get a bulge in money as we get into the spring, for one thing because of those [tax] refunds. Isn't that the time to do the tightening if there's going to be a tightening--when we have a demonstrated increase in the money supply?

MR. WALLICH. It raises a problem.

CHAIRMAN VOLCKER. Given the most recent behavior of the published money supply and given the value in some continuity and not wanting a feeling of too much fine-tuning when nothing is clearly going wrong, I would suggest that we reiterate the directive that we had last time which says 4 to 5 percent [on M1]. I think we have to change the M2 figure because of the change in the definition of M2.

MR. AXILROD. Do you want to add M-1B into the directive also?

CHAIRMAN VOLCKER. We could add M-1B into the directive, but I think it ought to be done the same way, with a range, whatever the consistent number is.

MR. AXILROD. In our view it's--

CHAIRMAN VOLCKER. You think it's 3/4 of a point higher. I am surprised there's that much difference.

MR. AXILROD. In that period it was 3/4 of a point.

CHAIRMAN VOLCKER. Maybe we could say 4 to 5 percent for M-1A and 1/2 point higher for M-1B.

MR. AXILROD. About 1/2 point more.

CHAIRMAN VOLCKER. And 6-1/2 percent for M2. That looks a little--

MR. PARTEE. As newly defined.

CHAIRMAN VOLCKER. And we'd make it clear that these are the newly defined numbers.

MR. COLDWELL. Your borrowing level for "B" would be $1 billion?

MR. AXILROD. The average borrowing for January was $1.2 billion, and that's what we were suggesting as the initial level. I would add that, following that very sharp spurt in borrowing last week, partly because the Desk is aiming at [a lower level], borrowing has been running much lower this week; it's averaging about $892 million so far.

MR. COLDWELL. But consistent with "B," you're talking $1 billion?

MR. AXILROD. We mentioned $1.2 billion in the Bluebook. Previously, at the last meeting, $1 billion was discussed; but borrowing seemed to be running higher than that. So it's a fuzzy question as to where precisely borrowing is going to want to end up. But we suggested $1.2 billion.

CHAIRMAN VOLCKER. The borrowing figure has been very fuzzy recently, to say the least. Whatever figure we think about now might be adjusted fairly promptly in the light of whatever numbers come in. What I am saying, partly in the interest of consistency, is that we are looking for M-1A between 4 and 5 percent and M-1B between 4-1/2 and 5-1/2--or we could say 1/2 point higher. I don't know if there's any preference between those. Then there is somewhat of a technical problem in that we don't get the M2 figure as early, but I think it could be said that we believe this is consistent with an M2 figure, as newly defined, of about 6-1/2 percent.

MR. COLDWELL. That says that nothing has happened since the last time we discussed this.

CHAIRMAN VOLCKER. Basically, I think it does. That's the issue: Whether we want to take this opportunity to make a change in what we laid down a month ago.

MR. WALLICH. Well, I think there has been a distinct perception of a higher rate of inflation by the public. And there has been a challenge on whether or not we are still hanging in tough.

MR. SCHULTZ. I think alternative B represents some restraint. Restraint is continuing and we're beginning to see it in the things that I called attention to. I would not like to see us change from alternative B.

MR. PARTEE. The only reason we don't have a considerable shortfall is because of that seasonal adjustment. Otherwise, we are hanging with a policy that gives us a shortfall.

CHAIRMAN VOLCKER. Well, this is the issue. It involves not just what we want to do now but has some future implications as to how much we want to fine-tune these numbers at monthly intervals or the intervals at which we meet. Sometimes we are going to want to change them, I think, so I am not completely allergic to it. This would be a very small change between "B" and "C."

MR. COLDWELL. It's also partly a perception of front-end loading.

CHAIRMAN VOLCKER. Consistent with the decision we just made for the long run, "B" has a very slight amount of front-end loading, if you mean by front-end loading going below the--

MR. COLDWELL. More restraint.

MS. TEETERS. Well the January-to-March growth implied by "B" is well below what happened in January. So, by definition, we're going to get some tightening.

CHAIRMAN VOLCKER. In any event, we will get a slight amount if these numbers come out that precisely. All these numbers imply a slightly slower rate of growth than what we actually had in January. And I think we could say in the policy record at the very least that that implication exists.

MR. BALLES. Mr. Chairman, if it's your preference to state this as ranges of 4 to 5 percent and 4-1/2 to 5-1/2 percent, is the implication that the Desk would aim for the midpoint?

CHAIRMAN VOLCKER. Yes, I think that is true for this period. I have a slight preference for a range just because we are never going to hit the exact figure anyway--we're not that good--and it just indicates that there's a little [flexibility]. But the implication clearly is that for now we aim for the midpoint. Now, what we do as the period [progresses] if we get outside it in either direction and whether it's practical to get all the way back to the midpoint [is the question]. There is some flexibility [with a range], but I don't feel strongly as to whether it's stated as a midpoint or--

MR. BALLES. With the understanding, whether it's in the record or not, that we would in fact [aim] for the midpoint, I for one would find it acceptable. My preference would be to be a little more precise in the instructions to the Desk as to what to aim for and recognize that we might not be able to hit it.

CHAIRMAN VOLCKER. Well, let's separate these two questions. Let me just get a show of hands. Who basically wants to keep the midpoint where we had it, with the modification that means [given] a change in the [M2] definition, but does not want to say that we want a different basic [objective for] money growth in the first quarter? This recognizes that that means a slightly lower rate of growth in February and March than we in fact had in January.

MR. ALTMANN. Nine, Mr. Chairman.

CHAIRMAN VOLCKER. Well, that seems to be the preference. The subsidiary question--I think it is distinctly subsidiary--is whether you want to word it the way we did last time, as I suggested with the new definitions, or do you want to word it as 4-1/2 percent?

MS. TEETERS. I would prefer to word it the way we did last time.

CHAIRMAN VOLCKER. Could we have a show of hands on that?

MR. ALTMANN. Five.

CHAIRMAN VOLCKER. Maybe we want to word it the other way then. It's about evenly split, but I--

MR. PARTEE. I think we're better off stating them all as "abouts"--"about 5" and I guess "about 6-1/2."

CHAIRMAN VOLCKER. All right. The alternative is saying about 4-1/2 percent and--. Well, I think the 6-1/2 percent ought to be worded differently because we don't have that number right away and we can't have the implication that we're following that week by week because we just don't have it. So, with that change in language, it's 4-1/2 percent for M-1A and 5 percent for M-1B, which I notice is halfway between "B" and "C." And then "The Committee believes that is consistent with about 6-1/2 percent for M2 as newly defined."

MR. MAYO. How do you explain, Paul, why we have a point target even with the "about" in front of it for the short run and we have a range for the long run?

MR. PARTEE. Because that's the way the Manager [operates].

MR. STERNLIGHT. We run on a reserve path. What we're aiming for is a reserve path that's built on the midpoint if you pick a range or the approximate point if you pick an approximate point.

CHAIRMAN VOLCKER. I hate to introduce this again, but what we did once was to say 4-1/2 percent--it happened to be 4-1/2 [unintelligible]--and it was clear in the record, though I forget just how, that lower was better than higher.

MR. PARTEE. But that still seems to me an instruction to the Manager.

MR. MAYO. It's an instruction to the Desk. Okay, I buy that.

MR. PARTEE. The last paragraph still has [unintelligible] but in the second [to last] paragraph the instruction is to run his reserve [operations] so as to be consistent with growth of about 4-1/2 percent.

CHAIRMAN VOLCKER. I think that's right.

MR. PARTEE. He's going to miss--maybe or probably.

CHAIRMAN VOLCKER. But I don't really think it makes any difference what instruction will be given to the Manager [initially]. The [question] is whether or not to put people on notice that nobody is good enough to meet [a precise] target, and we may imply that by using a small range. But I don't think it's a very significant question. Shall we vote? It's 4-1/2, 5, and 6-1/2 percent stated as "abouts."

MR. PARTEE. Initial borrowing is at $1.2 billion or about $1-1/4 billion?

CHAIRMAN VOLCKER. Borrowing is at $1-1/4 billion, let's say. Okay.

MR. ALTMANN.

Chairman Volcker	Yes
President Balles	Yes
President Black	Yes
Governor Coldwell	No
President Kimbrel	Yes
President Mayo	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Schultz	Yes
Governor Teeters	Yes
First Vice President Timlen	Yes
Governor Wallich	No

Nine for, two against.

CHAIRMAN VOLCKER. I will take up the scheduling at lunch. Thank you.

END OF MEETING

APPENDIX

FOMC PRESENTATION
E.M. Truman
February 4, 1980

Introduction

Mr. Chairman, we have prepared for the Committee a background presentation on "international financial trends." U.S. monetary policy decisions affect such trends and, to some extent, may be affected by them. With that in mind, and using the package of materials before you, Jeff Shafer and George Henry will review some of the economic and financial factors influencing exchange market developments and some of the international financial implications of the oil situation. When they have finished, I will offer a few concluding comments.

Mr. Shafer.

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FOMC PRESENTATION
Jeff Shafer
February 4, 1980

The red line in the top panel of Chart 1 shows the weighted-average foreign exchange value of the dollar since 1973 -- the begininning of the floating exchange rate period. The black line shows the ratio of foreign to U.S. consumer prices.

From March 1973 to 1976 the trend of the dollar, although obscured by sizable fluctuations, appears to follow the rising path of foreign prices relative to U.S. prices. The decline of the dollar since then has been associated with a downward movement of prices abroad relative to prices here. But the slide of the dollar has been much steeper than the trend in relative prices. The bottom panel shows the resulting drop in one measure of the price-adjusted average value of the dollar-- or what is often referred to as the real exchange rate.

Chart 2 plots bilateral movements of the dollar against the currencies of Germany, Japan, Switzerland and the United Kingdom, together with the ratio of the price level in each of these economies to the U.S. price level. The chart indicates a general correspondence between price trends and exchange rate trends. Since March 1973, the dollar has depreciated against the currencies of the top three countries, where prices have risen more slowly than in the United States. It rose against the U.K. pound through 1976, in line with the more rapid rate of price increase in the United Kingdom. But since then, the dollar exchange rate against the pound has fallen below the trend of relative prices, as factors such as North Sea oil contributed to a strengthening of pound.

Relative price movements are clearly an important element in accounting for trends in the dollar. In 1980, the staff expects prices abroad to rise more slowly than U.S. prices, but probably by only one or two percent. Price increases in Germany and Switzerland, however, are expected to be substantially less than in the United States.

Several factors have operated since March 1973 to cause dollar exchange rates to deviate from the path of relative prices. Chart 3 provides a perspective on the relationship between interest rate developments and the exchange market performance of the dollar. The weighted-average exchange rate for the dollar is shown again in the top panel.

The middle panel shows the 90 day interest rate on U.S. CDs in red and a weighted-average of 3-month foreign interest rates in black. As can be seen from the Chart, U.S. and foreign interest rate movements have been broadly parallel. The red line in the bottom panel shows the movements in the differential between U.S. and average foreign interest rates that have occurred. For comparison, the black line presents the differential between the U.S. inflation rate and the average foreign inflation rate over the previous 12 months. Longer-term movements in the interest rate differential have tended to follow the inflation differential.

One episode in which short-run interest rate developments deviated from inflation developments and had a significant short-run impact on the dollar occurred from late 1974 to late 1975. During this period the drop in U.S. interest rates relative to foreign interest rates and the subsequent reversal were parallelled by a decline in the dollar and then a recovery. In contrast with this episode, the dollar remained firm in 1976 even though U.S. interest rates fell behind rising foreign interest rates while the inflation differential was stable. This pattern reflects the behavior of several foreign central banks which raised interest rates sharply to moderate depreciations of their currencies.

The three panels in Chart 4 repeat for the German mark and the dollar the same comparisons made in Chart 3. The bottom panel shows that from March 1973 through 1975 sizable fluctuations in relative interest rates corresponded reasonably well with short-run fluctuations in the mark-dollar exchange rate. But from late 1975 through late 1978 the interest differential and inflation differential between the two countries tracked rather closely. Over this period the dollar followed a weakening trend against the mark, but short-run fluctuations about this trend were small. Despite a narrowing of the differential between U.S. and German interest rates in 1979, with no reduction in the inflation differential, the dollar declined only moderately against the mark.

For the record, in 1980, we expect interest rates abroad to remain in their recent range on average, including in Germany.

Shifting demands for assets denominated in dollars, for reasons other than movements of relative price levels or rates of return, also influence dollar exchange rates. For example, it has been argued that the advent of floating exchange rates has provided an incentive for official holders of dollars to diversify into other currencies in order to reduce the variability in the value of their reserves. Chart 5 summarizes some evidence concerning diversification. The top panel shows the evolution of the composition of the foreign exchange reserves of a sample of 76 countries.

The chart suggests that since 1973 there has been no secular trend of diversification out of dollars. Rather, the share of sterling has declined markedly while the shares of marks and other currencies have risen. The dollar share of reserves rose from 1973 to 1976 and has declined moderately since 1977. It was still well above its 1973 low in September 1979. The decline in the dollar's share since 1977 is largely attributable to the effects of exchange rate changes on the valuation of reserves rather than to sales of dollars for other currencies or major shifts in the currency distribution of additions to reserves.

More recently there have been reports of some OPEC diversification; but we have no evidence that, aside from Iran, large shifts have occurred. Looking ahead, if the dollar weakens for other reasons, official diversification, or fear of it in the aftermath of the Iranian asset freeze, may add to the downward pressures on the dollar. But the evidence suggests that if other factors become favorable for the dollar, official reserve management might not be a negative factor and indeed might over time even have a positive effect.

The lower panel on the Chart shows the currency composition of Euro-currency liabilities. This Chart is presented to give a rough indication of trends in private as well as official use of the dollar. The movements of currency shares here roughly parallel those for official reserves.

Chart 6 presents data on official exchange market intervention in dollars by major countries. The middle panel shows net official dollar purchases by foreign central banks and by the United States. It indicates that the scale of net dollar intervention increased sharply in 1977 and has remained greater than in the earlier part of the floating rate period. Until 1978 most of the net intervention was undertaken by foreign central banks. In 1978 and 1979 the United States took a larger share.

In general, intervention purchases of dollars have occurred when the dollar has been weak, thereby moderating its decline, and sales have occurred when it has been strong, or to unwind previous intervention when the dollar has been at least stable. In 1974, however, net dollar sales occurred even though the dollar declined over the year. And in the second half of 1979 U.S. purchases of dollars to counter downward pressure in exchange markets were offset by the net official sales of foreign central banks. Intervention that runs counter to the trend of the dollar's value, or that is offsetting among countries, reflects the reserve and intervention currency roles of the dollar. Some of the differences in intervention by individual central banks can be seen in the bottom panel where net dollar purchases by Germany, Japan, and other countries are shown. Years in which intervention by the three have been in opposite directions have been common.

Assessment of the effects of intervention on exchange rates is difficult, since a judgment as to how much further a currency might have moved in the absence of intervention is required. Moreover, in most episodes of dramatic success, intervention has been initiated in conjunction with new monetary or other policy actions. The principal effect of intervention under such circumstances may be to underscore the importance authorities attach to the exchange rate in setting and executing their overall economic policies.

George Henry will continue our presentation.

<u>FOMC PRESENTATION</u>
George B. Henry
February 4, 1980

Complementing the factors that Mr. Shafer has reviewed, especially the influence of relative price levels, the behavior of the U.S. current-account position in 1977 and 1978 helps to explain the decline in the value of the dollar in those years. Perhaps the most important channel through which current-account developments affect exchange rates is by influencing expectations concerning rate adjustments that may be required to achieve sustainable external positions over time. How current-account developments affect expectations will depend on the market's view of the underlying factors at work. As can be seen from a comparison of the panels in Chart 7, the declining U.S. current-account position in 1976, attributed at the time to temporary cyclical factors, was associated with an appreciating dollar. The cyclical character of these developments was called into question by the further sharp decline in our balance in 1977 and substantial downward pressure on the dollar emerged.

Recently, the U.S. current account has improved notably. Substantial growth in net service receipts has contributed importantly to this favorable swing. As shown in the top panel of Chart 8, growing income on net investment abroad has recently been a dynamic factor. Net investment-income receipts now exceed $30 billion, of which approximately half is reinvested abroad.

Our trade position also has exhibited large shifts in recent years. The balance excluding agricultural exports and oil imports is shown in the second panel of the chart; it declined steadily and sharply from the recession-induced surplus of 1975 through the beginning of 1978. It has shown an equally dramatic improvement over the past two years and is now nearing surplus. As can be seen from the final two panels, this improvement has reflected substantial growth in the volume of our non-agricultural exports and stable non-oil imports -- both largely attributable to the earlier depreciation of the dollar.

Our projections suggest that the current account is not likely to be a bearish factor for the dollar at least after the first half of this year. These projections fold in the huge increases in our bill for imported oil (depicted in Chart 9) that have occurred and are expected to continue. Similar increases, of course, have affected every oil-importing country and they have affected as well the external position of OPEC.

As can be seen in Table 1, line 3, the initially huge OPEC current-account surplus in 1974 had virtually disappeared by 1978. The deficits of the non-oil developing countries, which peaked in 1975, had been worked down to more reasonable levels by 1977. The big oil-price increases of 1979 have taken us back to square one if not beyond; we project an OPEC surplus of $100 billion or more in 1980 and a very substantial widening in the deficits of non-oil developing countries. These prospects raise anew the so-called "recycling question," that is, the capacity of the international financial system to handle OPEC's surplus and to channel funds to countries in deficit, in particular to developing countries.

Chart 10 provides some historical perspective on this question. As can be seen in the top panel, official flows to non-oil developing countries increased rather rapidly during the period of large and rising deficits in 1974-75; since 1975 official flows have risen more modestly. The middle panel shows that banking flows also rose sharply in 1974 and 1975, and then leveled off. But they have expanded again recently. As indicated in the final panel, developing countries as a group added substantial amounts to their gross reserves in every year after 1975.

Table 2 provides some detail on the recent behavior of bank claims on non-oil developing countries. Debts to banks rose as a share of total debt of these countries from about 25 percent in December 1973 to almost 45 percent at the end of 1979. Initially in 1973, and for several years thereafter, U.S. banks held more than half the claims, but since 1976 U.S. bank credits have risen much more slowly than have those of foreign banks -- and the U.S. share of the total has consequently fallen substantially.

The upper panel of Chart 11 plots total claims of U.S. banks on non-oil developing countries. Growth of these claims slowed over the past four years as international lending became a significant part of total portfolios. As is shown in the bottom panel of the chart, claims relative to bank capital and assets have remained essentially unchanged for about two years -- after having risen sharply earlier. One factor in the slower recent pace of lending to developing countries by U.S. banks may have been the low spreads that have recently prevailed on syndicated Eurocurrency credits. Moreover, some U.S. banks may have reached levels of exposure to certain major borrowing countries beyond which they would not have felt comfortable. Such a situation does not imply a cessation of increases in U.S. banks' lending to developing countries -- particularly if spreads were to rise; it more likely suggests a continuation of the moderate pace of lending of recent years.

At first blush, growth in bank credit to non-oil developing countries no faster than that of recent years would appear to suggest a distinct financing problem, since the deficits of these countries, shown in the upper panel of the final chart, are expected to be substantially enlarged in 1980 and 1981. I noted earlier, however, that borrowing in recent years has exceeded these countries' immediate financing requirements -- in fact, by about $10 billion per year on average over the past four years. Simply eliminating reserve increases by non-oil developing countries would thus significantly reduce borrowing requirements.

Moreover, as can be seen in the middle panel, increases in IMF quotas and the establishment of special facilities have substantially increased the availability of Fund resources. Some net use of reserves by non-oil developing countries may be called for in the future and, given the relatively high level of their reserves, this would not in itself be cause for alarm.

On balance, the prospective stresses in international financial markets, generated in large part by sharply rising energy prices, appear to be basically manageable -- but there are some potentially serious risks. These include: (1) the possibility of further large oil disruptions; (2) the possibility that developing countries may fail to take prompt steps that would reduce their deficits over time and, consequently, that severe economic adjustment on the part of a number of those countries will ultimately be required in order for them to service their debts; or (3) the possibility that countries, developed as well as developing, will impose trade restrictions in an effort to ameliorate their own difficulties.

Ted Truman will now conclude our presentation.

E.M. Truman

Concluding Comments

One aspect of international developments that is of major concern to the Federal Reserve is the foreign exchange value of the dollar. For that reason, Mr. Shafer and Mr. Henry have reviewed the economic and financial factors that are commonly regarded as influencing the dollar's value.

No one factor should be regarded as dominating the determination of the dollar's foreign exchange value over all time periods. Nevertheless, over the longer run--measured in years--a central role must be assigned to monetary policy. But the long run often is not the focus of immediate concern. And it is much more difficult to sort out the direct influence of various factors in the short run--measured in months.

One way to summarize the short-run influences on the dollar is to think in terms of the demand for dollar-denominated assets. That demand can be viewed as being determined in the short run by two factors: the nominal interest-rate differential and the <u>expected</u> exchange-rate change. If U.S. interest rates decline relative to foreign interest rates, everything else being equal, the quantity of dollar-denominated assets demanded and, hence, the exchange value of the dollar would be expected to decline.

But everything else may not be equal. Specifically, the complex of factors that bear on the <u>expected</u> exchange-rate change may not remain constant. These include the other factors Jeff and George reviewed: relative inflation rates, diversification practices, intervention activity, and current account developments. In particular, the exchange rate is strongly influenced by what is expected to happen to economic variables and to policies affecting those variables. The market may react sharply based on its perception of changes in policies, especially those affecting inflation rates.

A broader area of Federal Reserve concern is the smooth functioning of the international financial system. As Mr. Henry has outlined, we believe that the overall situation with regard to current account surpluses and deficits, and their financing, in 1980 and 1981, is basically manageable. However, many countries face serious difficulties, and the capacity of developing countries to cope with their prospective, larger deficits without excessive reliance on new bank financing will depend to a considerable extent on whether the demand for their exports is reasonably well maintained.

Thus, there are risks, and they have increased significantly in recent months with the further rise in oil prices on top of an expected slowdown in global economic activity. These risks will be present even in a relatively stable international political environment, which may be an optimistic assumption. Disruptions in the international financial system would almost certainly spill over into exchange markets, although the implications for the foreign exchange value of the dollar might be either positive or negative. Perhaps more importantly, many such disruptions would have serious, adverse implications for inflation, for the health of the U.S. banking system, and for prospects for economic growth in the near and long term.

That concludes our presentation, Mr. Chairman.

CONFIDENTIAL (FR) CLASS II-FOMC

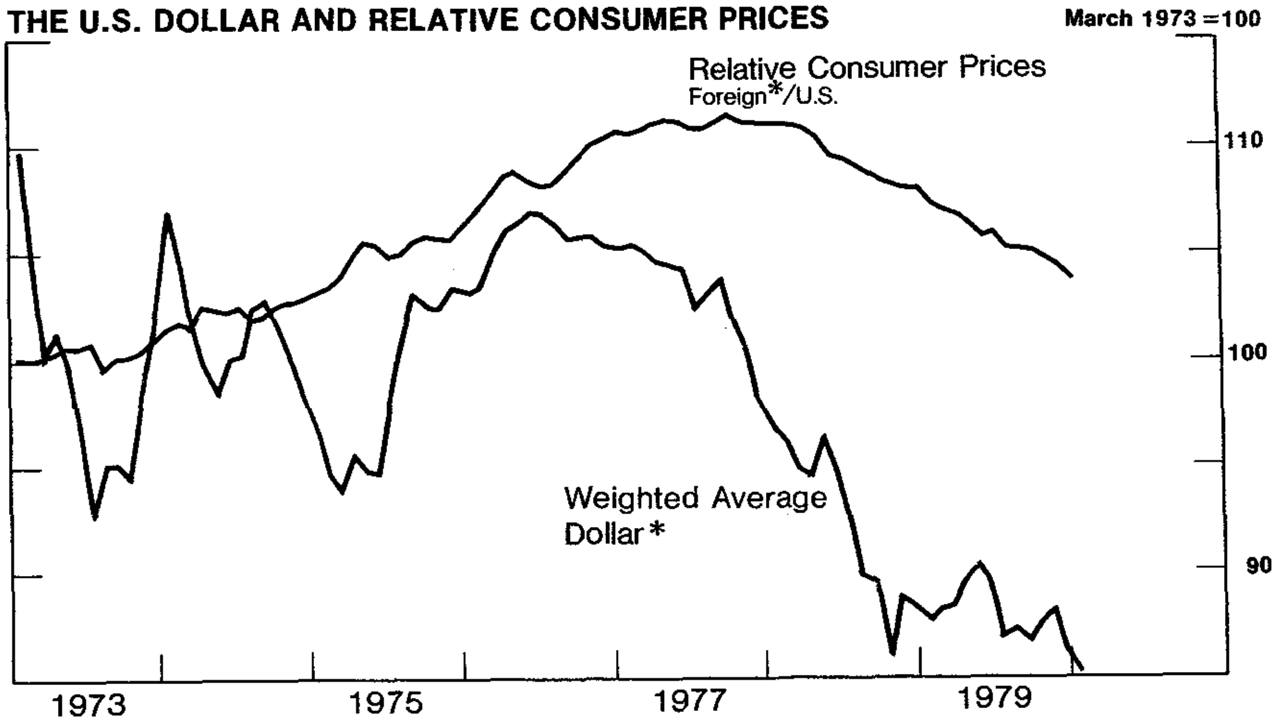
Material for
Staff Presentation to the
Federal Open Market Committee

"International Financial Trends"

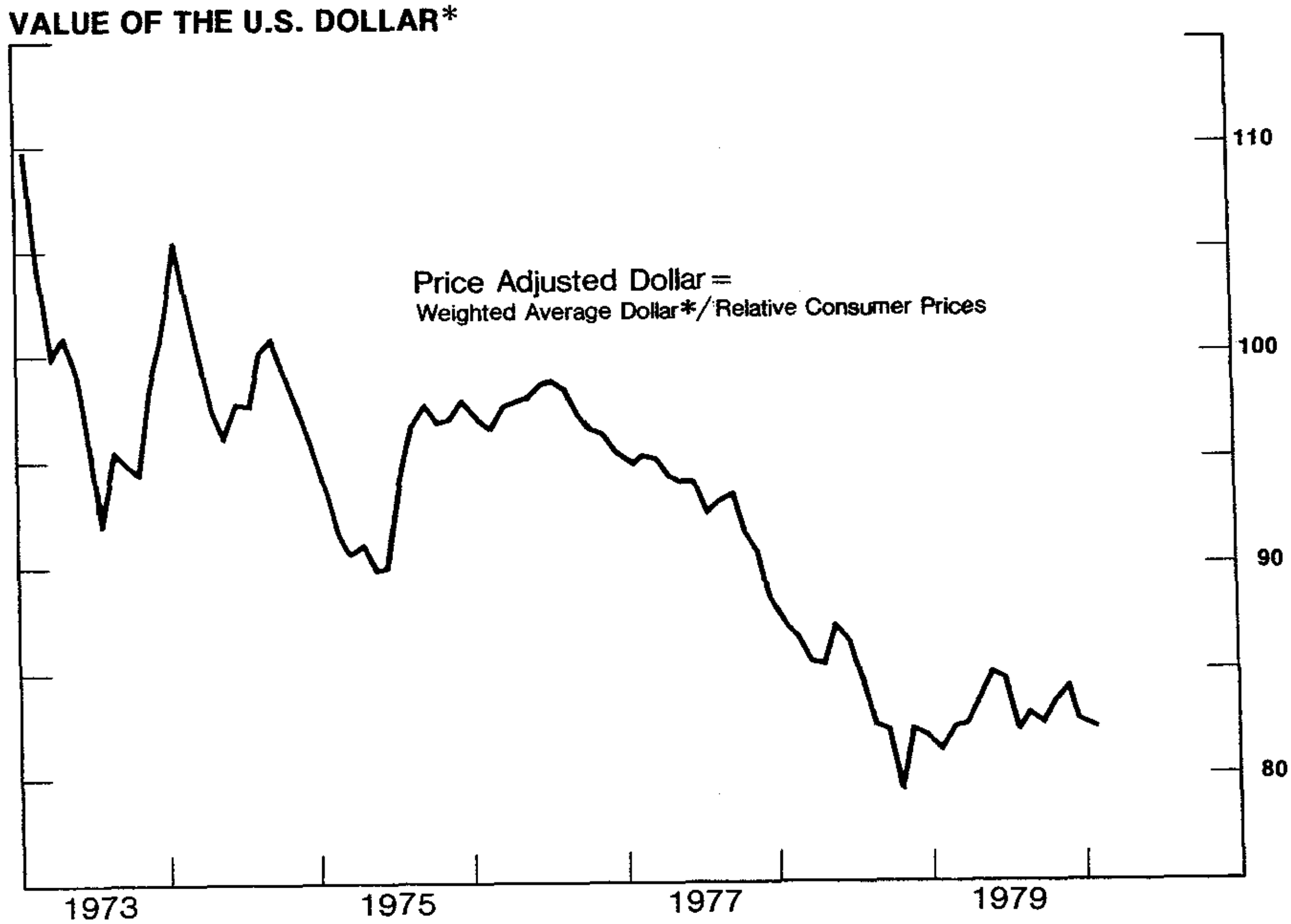
February 4, 1980

Chart 1

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR AND RELATIVE CONSUMER PRICES



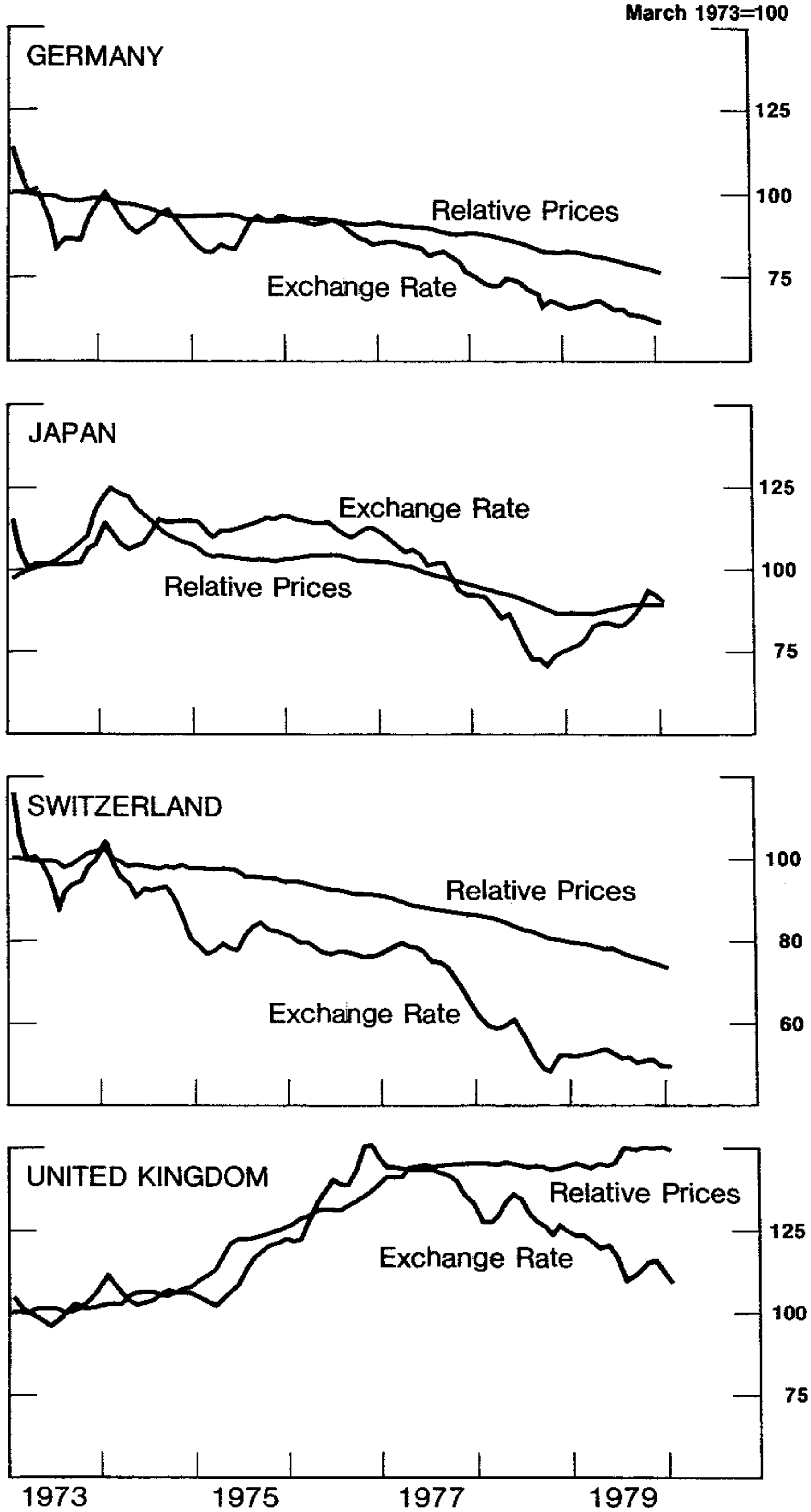
PRICE ADJUSTED WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR*



*Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

Chart 2

BILATERAL EXCHANGE RATES AND RELATIVE PRICE LEVELS*

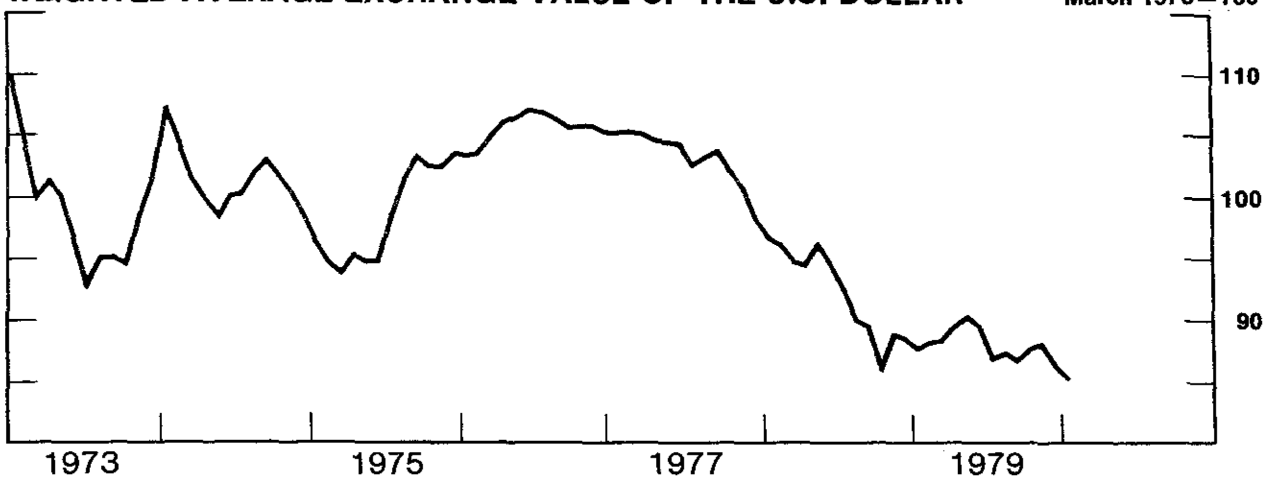


* Consumer prices, except for Japan where wholesale prices are used for Japan and the United States.

Chart 3

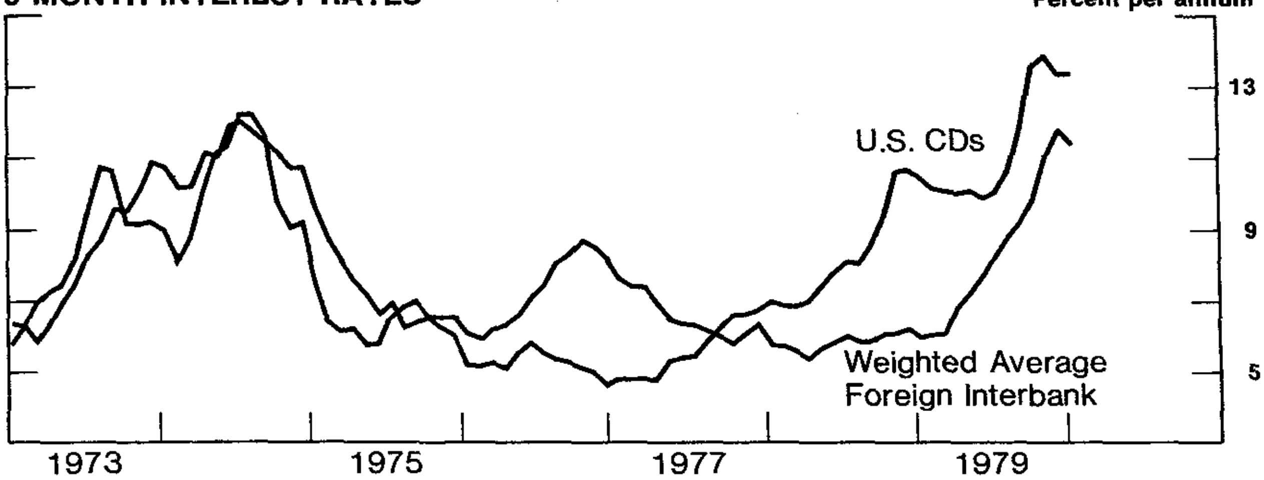
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR

March 1973=100



3-MONTH INTEREST RATES

Percent per annum



INTEREST RATE AND INFLATION DIFFERENTIALS
U.S. Minus Foreign

Percent per annum

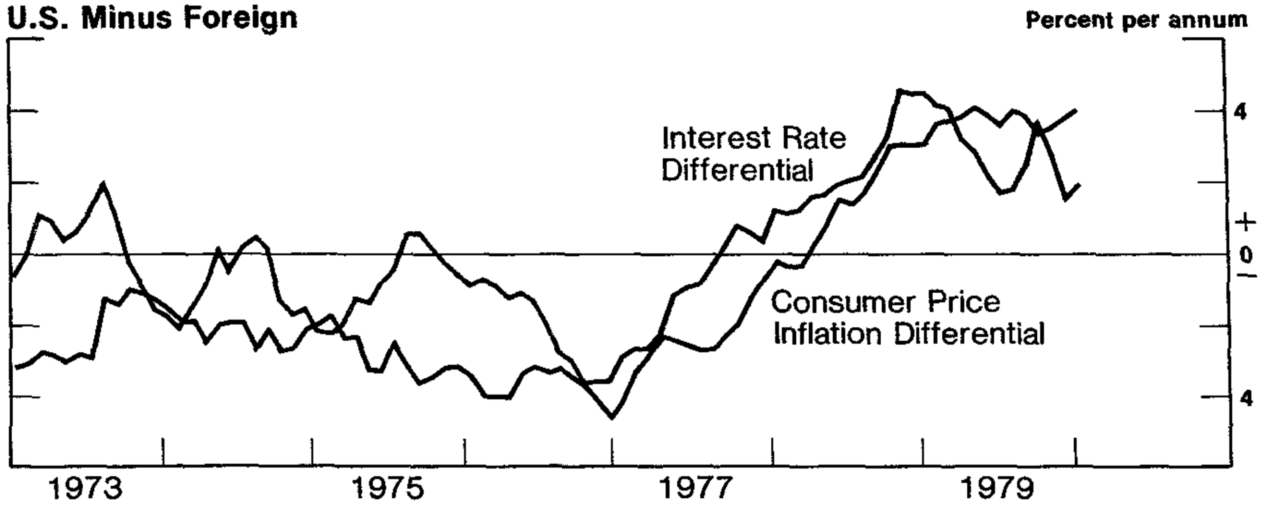
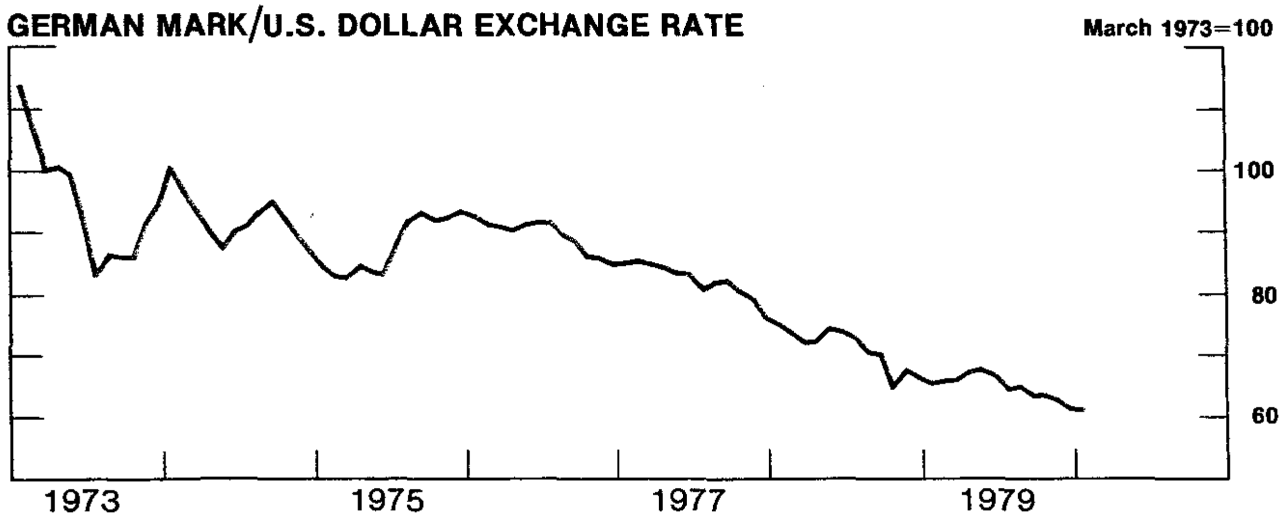
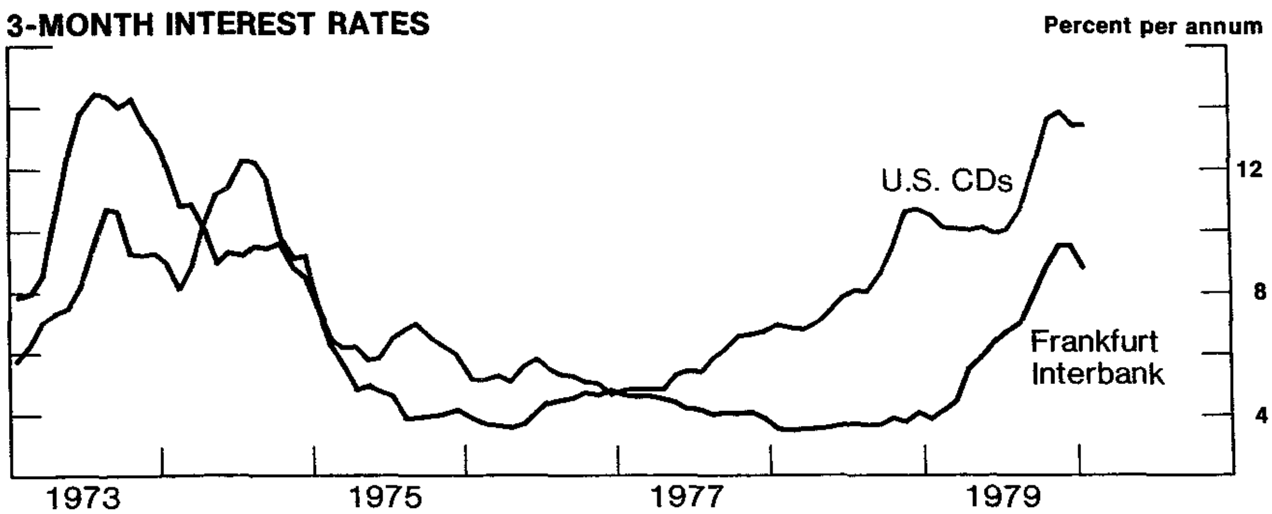


Chart 4


GERMAN MARK/U.S. DOLLAR EXCHANGE RATE
March 1973=100
100
80
60
1973
1975
1977
1979


3-MONTH INTEREST RATES
Percent per annum
U.S. CDs
Frankfurt
Interbank
12
8
4
1973
1975
1977
1979

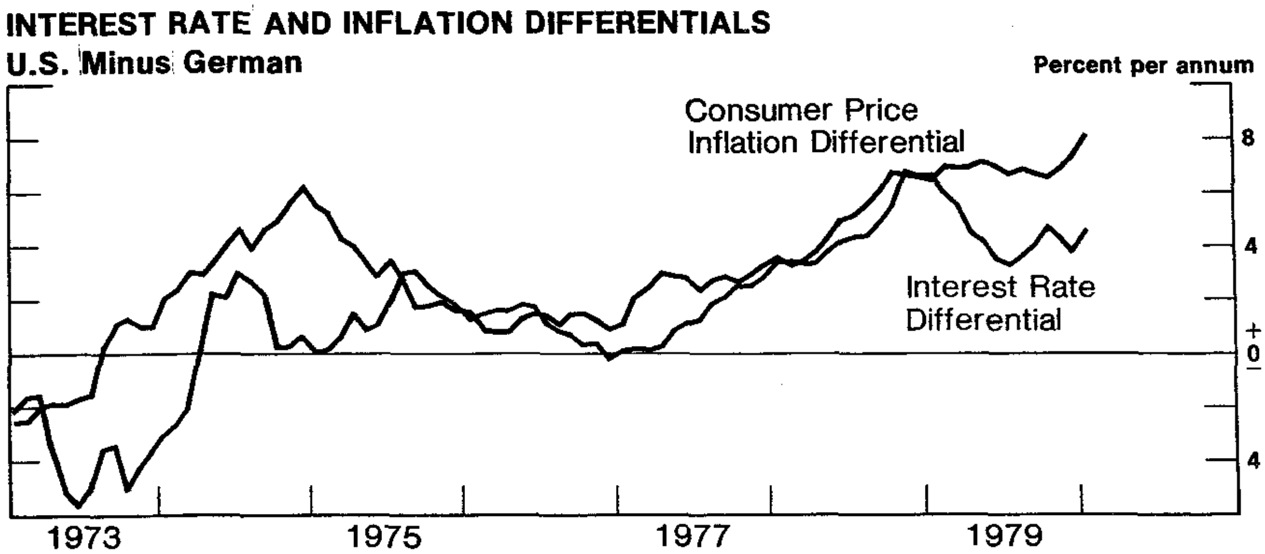
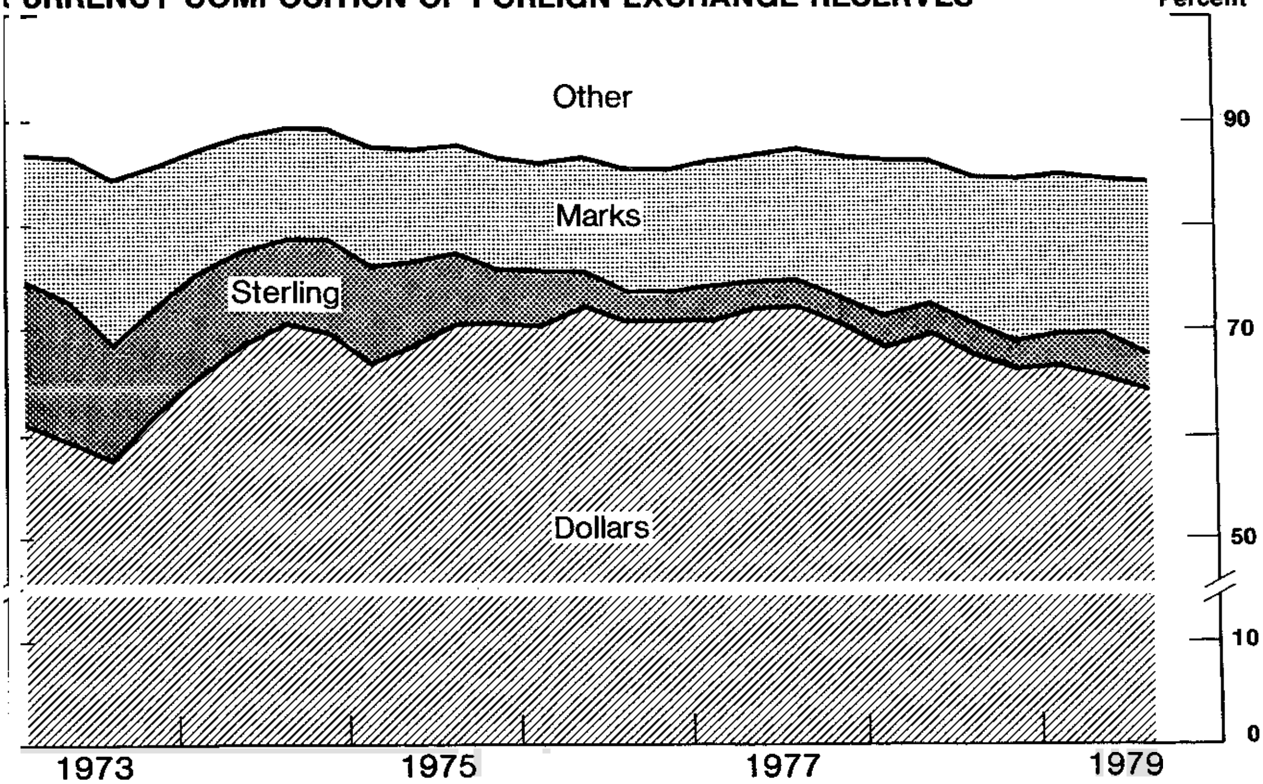
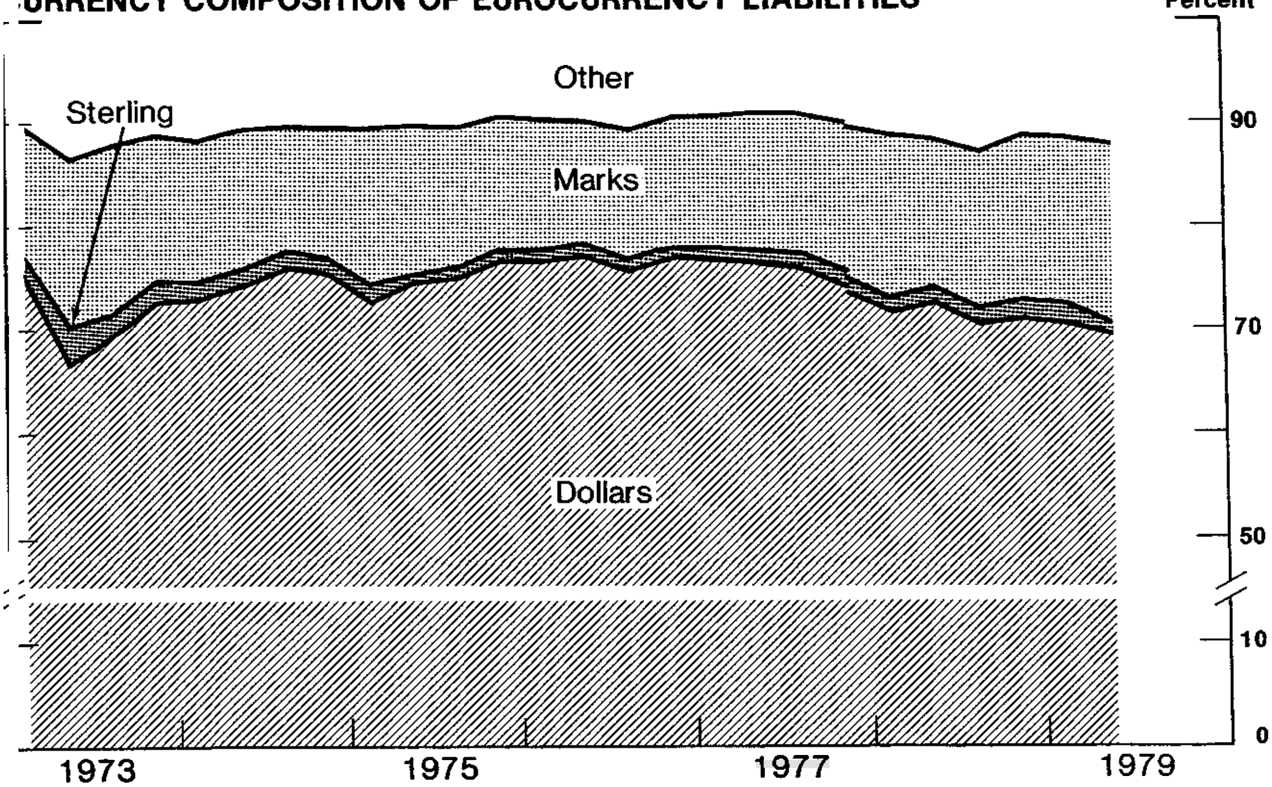

INTEREST RATE AND INFLATION DIFFERENTIALS
U.S. Minus German
Percent per annum
Consumer Price
Inflation Differential
Interest Rate
Differential
8
4
+
0
-
4
1973
1975
1977
1979

Chart 5

URRENCY COMPOSITION OF FOREIGN EXCHANGE RESERVES*



URRENCY COMPOSITION OF EUROCURRENCY LIABILITIES**

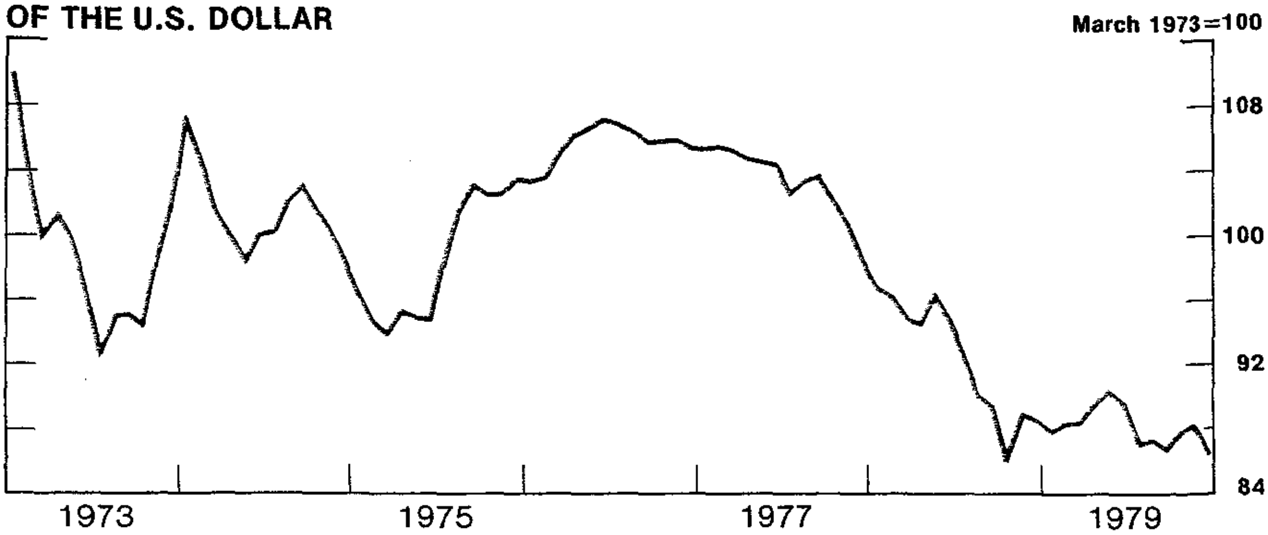


* Reserves of 76 countries, excluding reserve centers and countries that ~~have~~ not reported regularly to the IMF

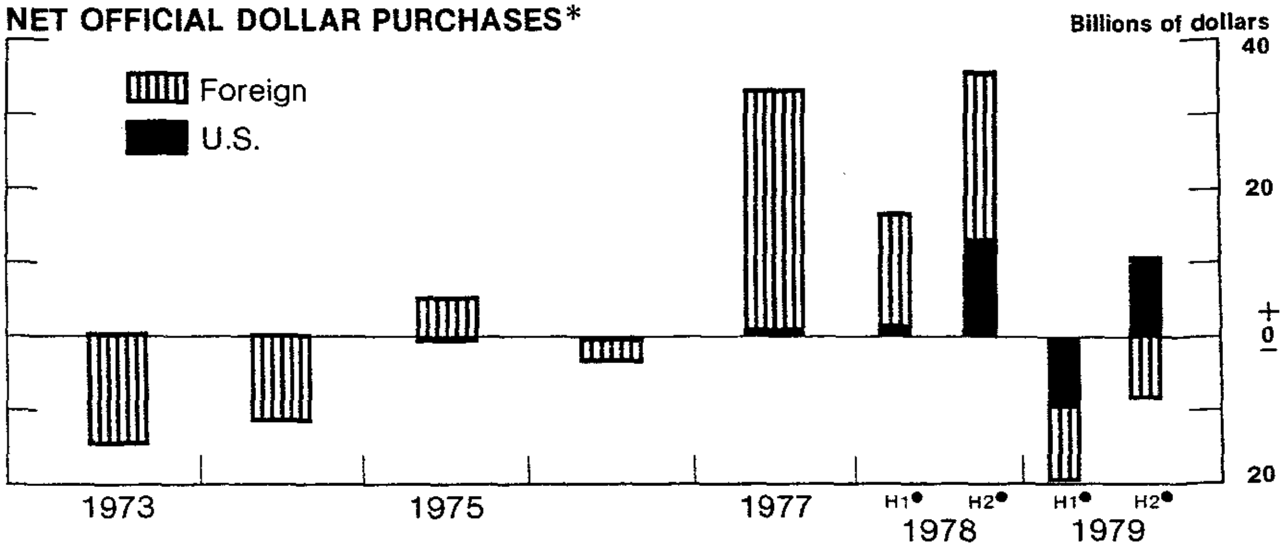
** Excluding liabilities in offshore banking centers

Chart 6

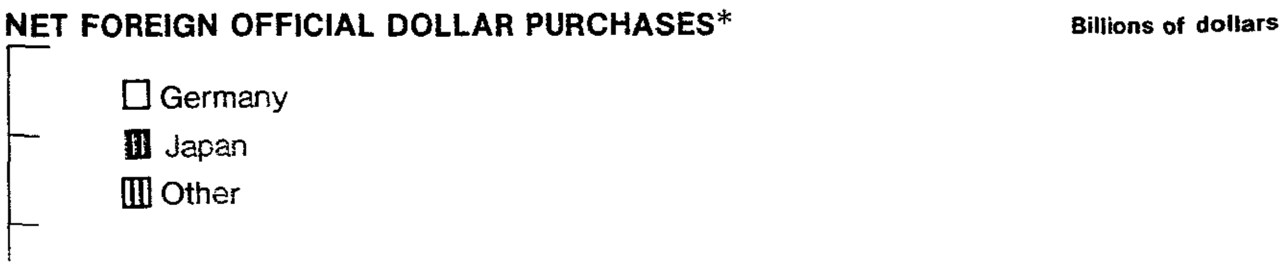
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



NET OFFICIAL DOLLAR PURCHASES*



NET FOREIGN OFFICIAL DOLLAR PURCHASES*

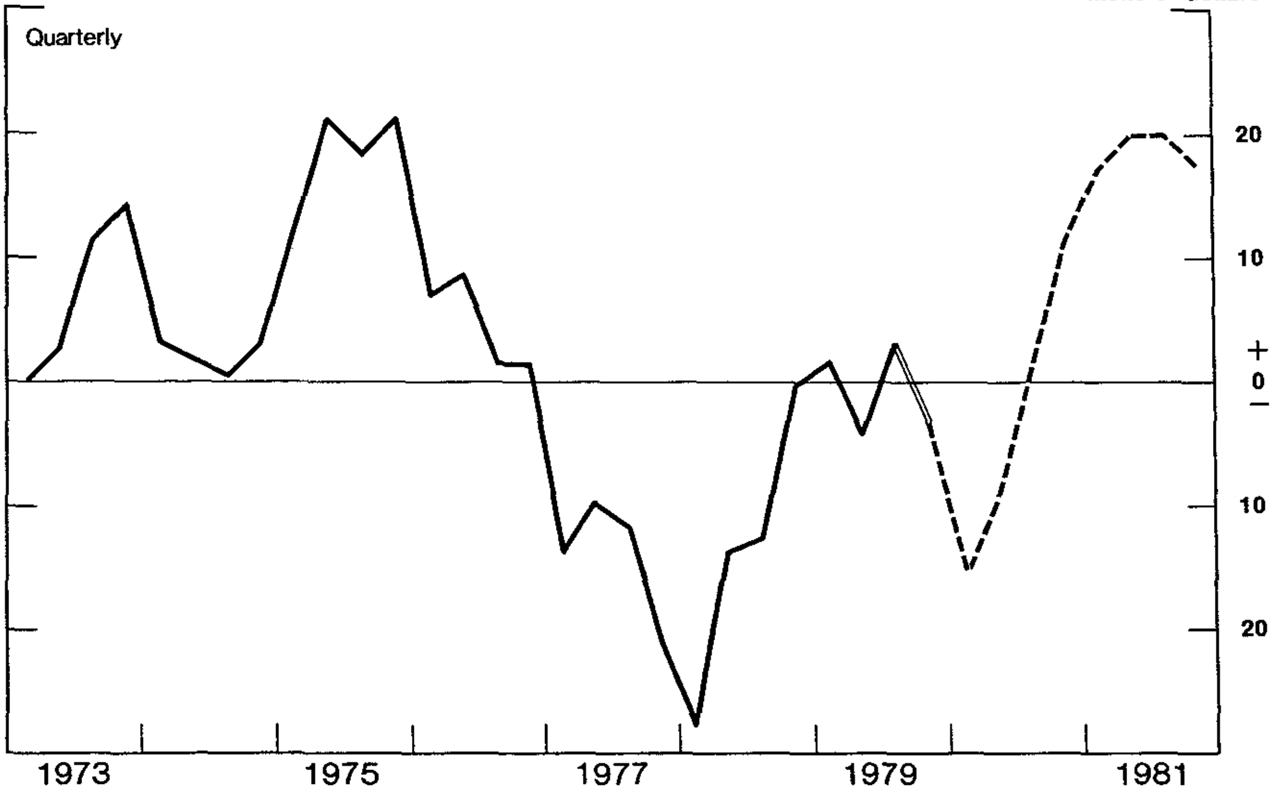


* G-10 countries plus Switzerland
● Annual rate

Chart 7

U.S. CURRENT ACCOUNT BALANCE

Seasonally adjusted, annual rate, billions of dollars



WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR

March 1973=100

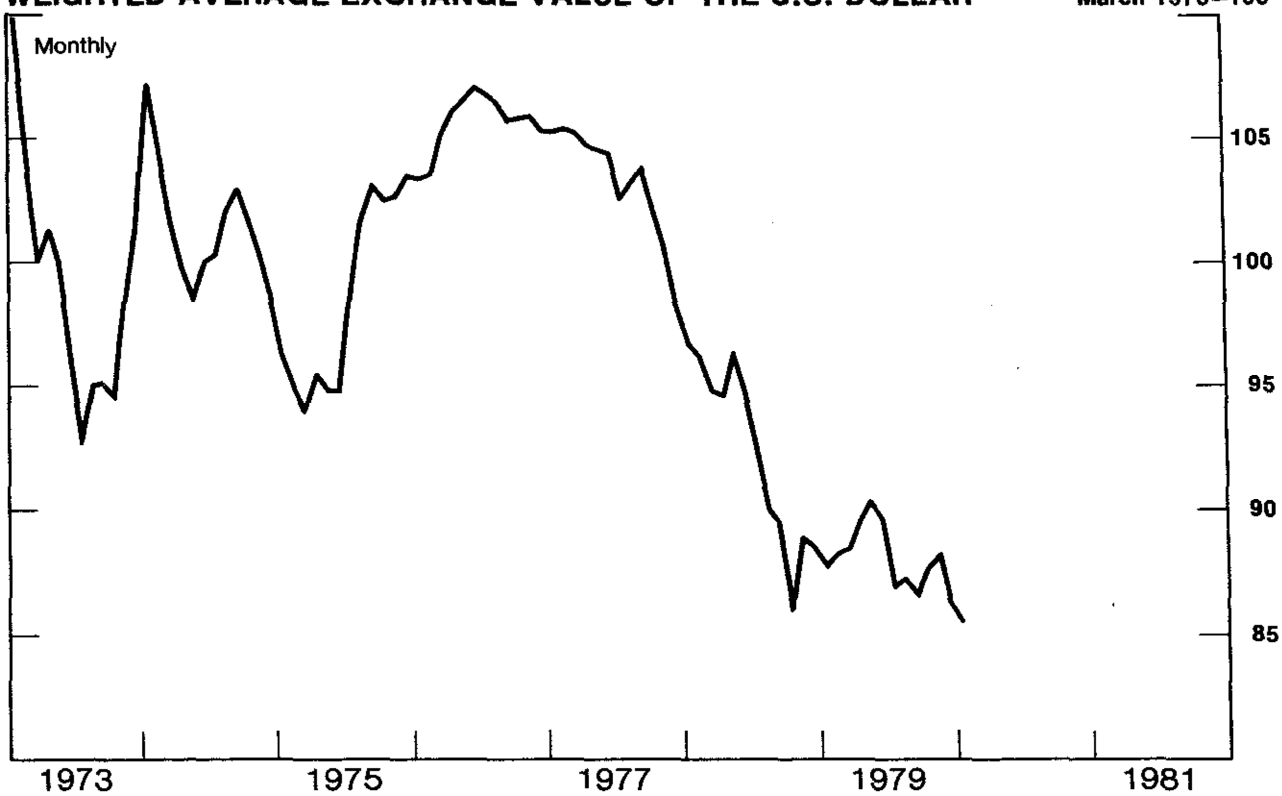


Chart 8

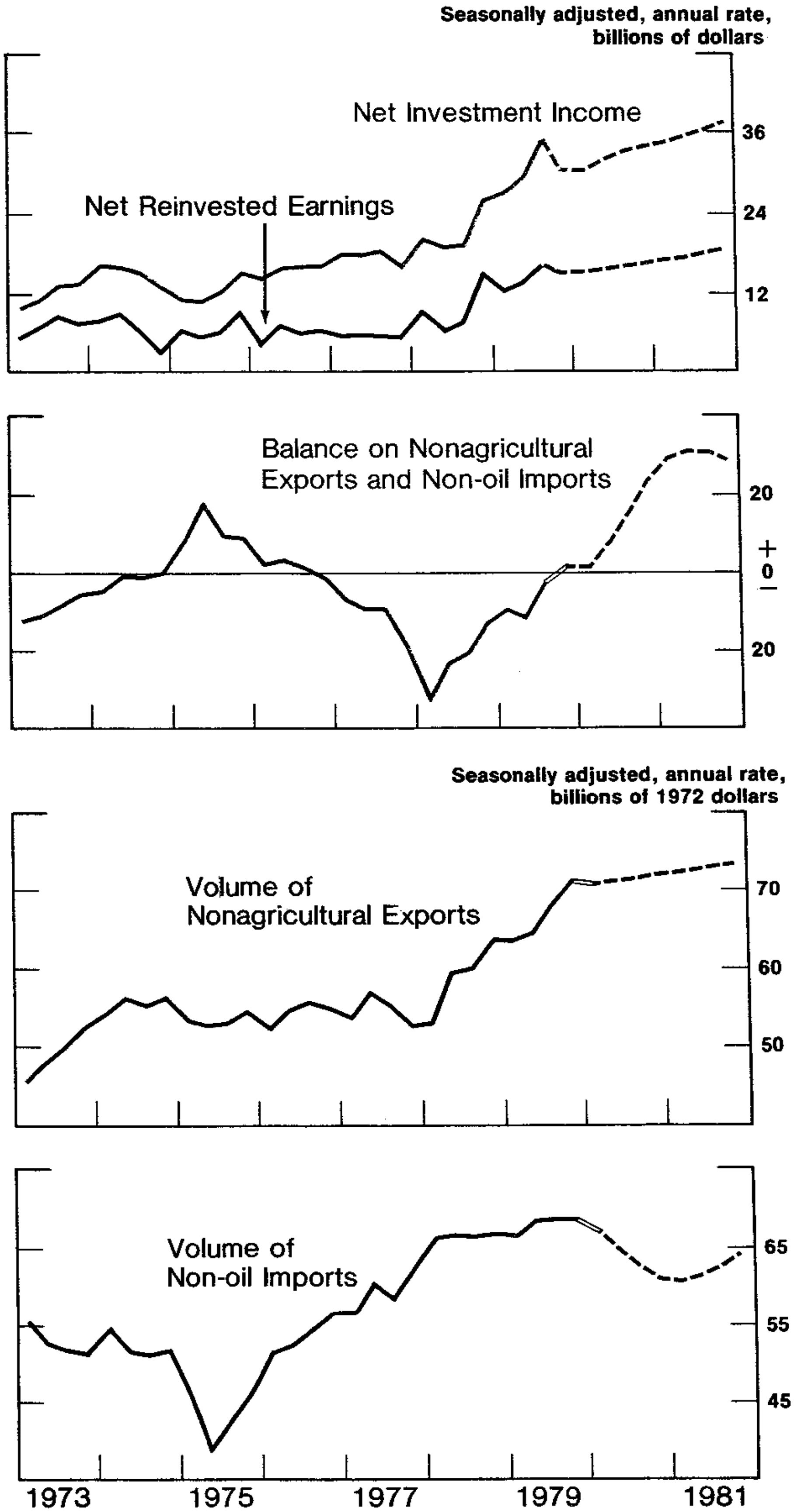

Seasonally adjusted, annual rate, billions of dollars
Net Investment Income
Net Reinvested Earnings
36
24
12
Balance on Nonagricultural Exports and Non-oil Imports
20
+
0
−
20
Seasonally adjusted, annual rate, billions of 1972 dollars
Volume of Nonagricultural Exports
70
60
50
Volume of Non-oil Imports
65
55
45
1973
1975
1977
1979
1981

Chart 9

OIL IMPORT BILLS

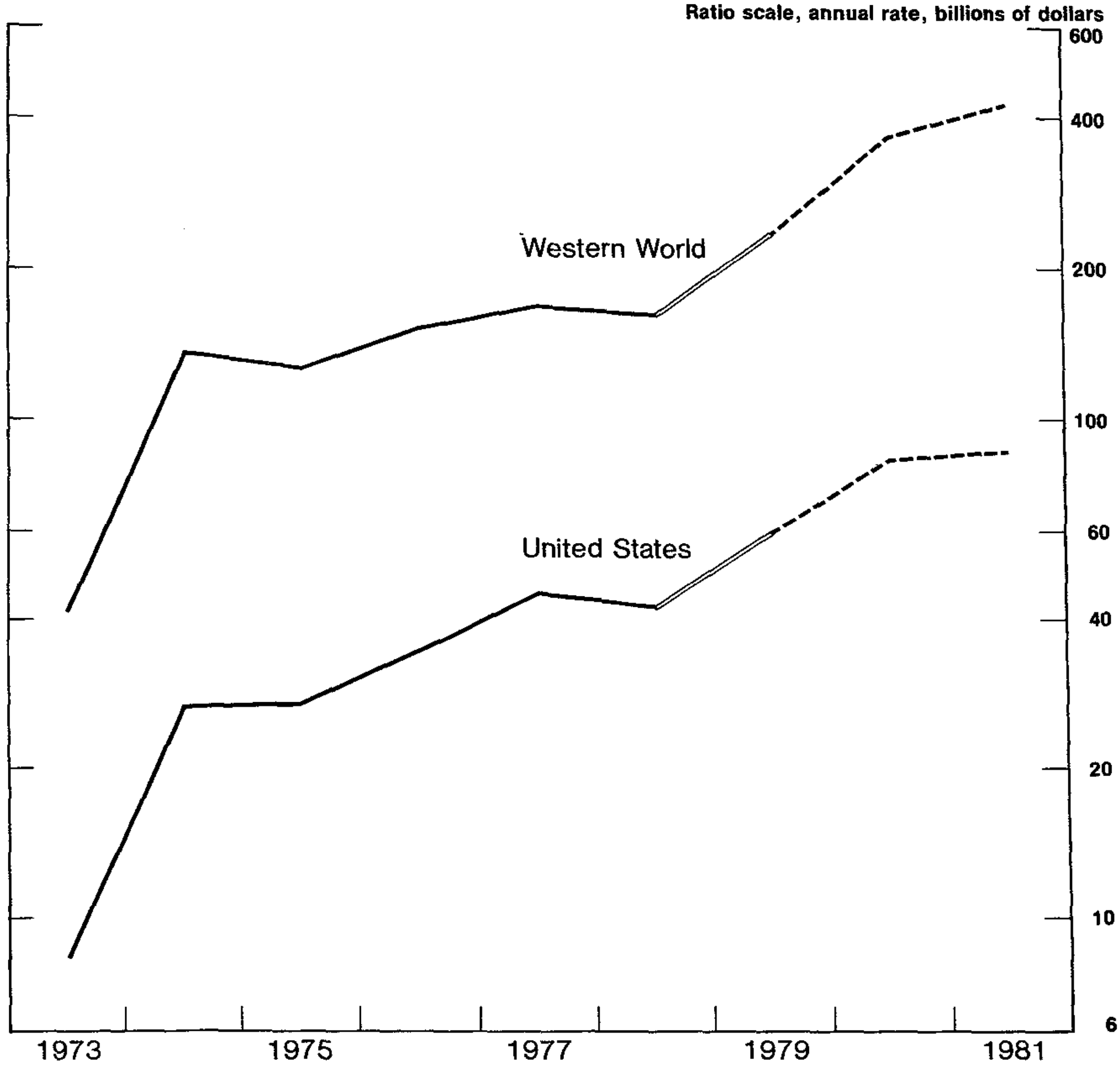


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Table I

GLOBAL CURRENT ACCOUNT BALANCES
Balances on Goods, Services, Private and Official Transfers; Billions of Dollars

	1973	1974	1975	1976	1977	1978	1979[e]	Staff Projection 1980	Staff Projection 1981
1. United States	7.1	4.3	18.3	4.6	-14.1	-13.5	-1.0	-3½	18½
2. Other OECD	3.0	-31.4	-18.7	-22.8	-10.7	22.6	-32.5	-58½	-49
3. OPEC	8.0	70.0	31.0	37.0	30.0	7.0	65.0	113	91
4. Non-oil Developing Countries	-7.1	-24.2	-32.0	-20.2	-14.5	-25.7	-39.0	-58	-61
5. Other[1/]	-3.5	-9.5	-18.5	-13.0	-8.5	-9.5	11.0	-12	-13

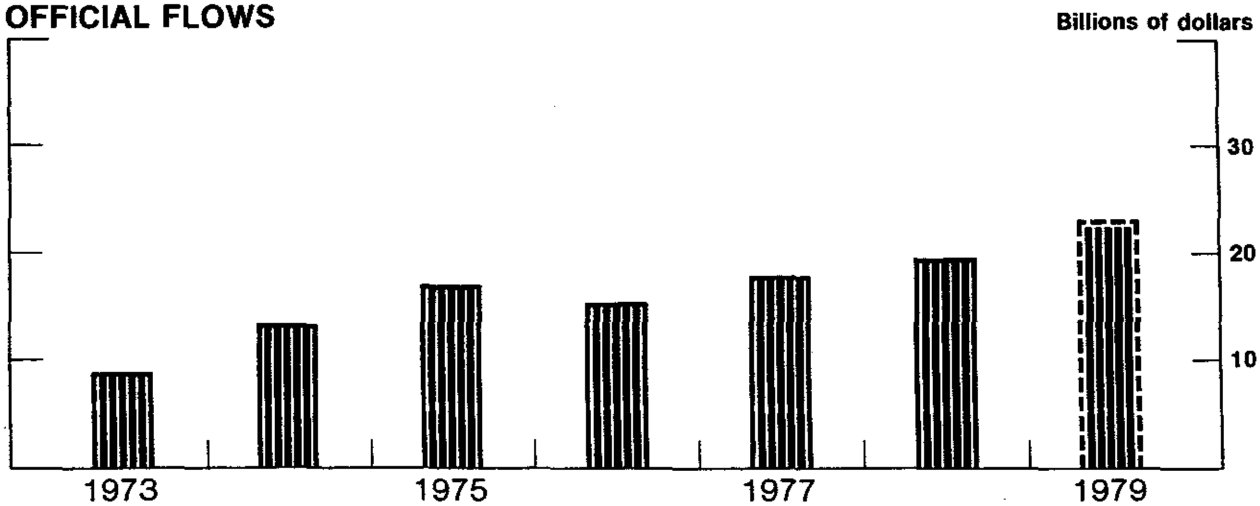
1/ Principally Sino-Soviet area and East European countries.

e = estimate

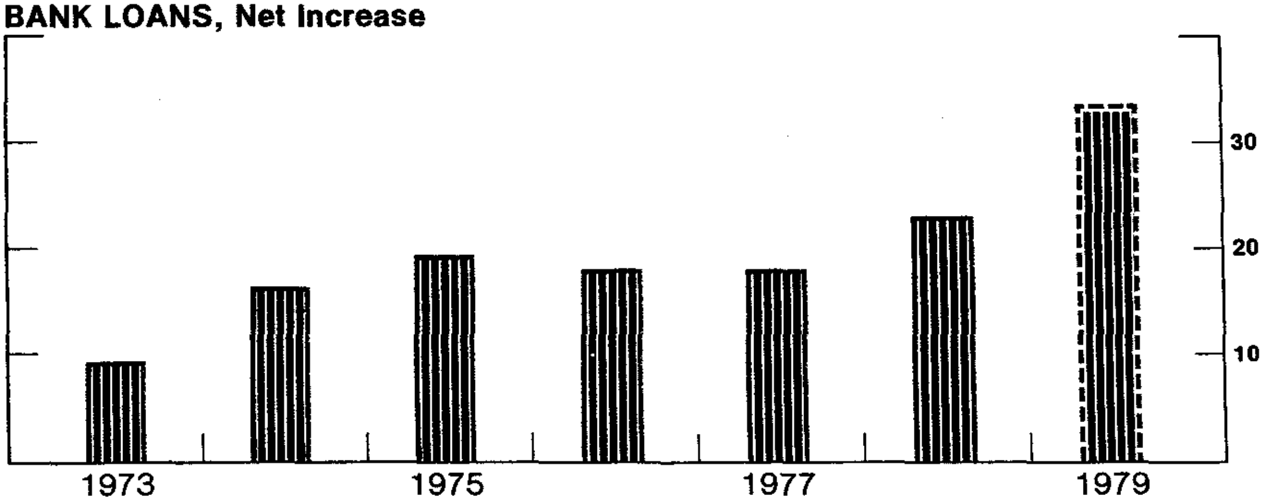
Chart 10

FINANCIAL FLOWS OF NON-OIL DEVELOPING COUNTRIES

OFFICIAL FLOWS



BANK LOANS, Net Increase



RESERVE CHANGES

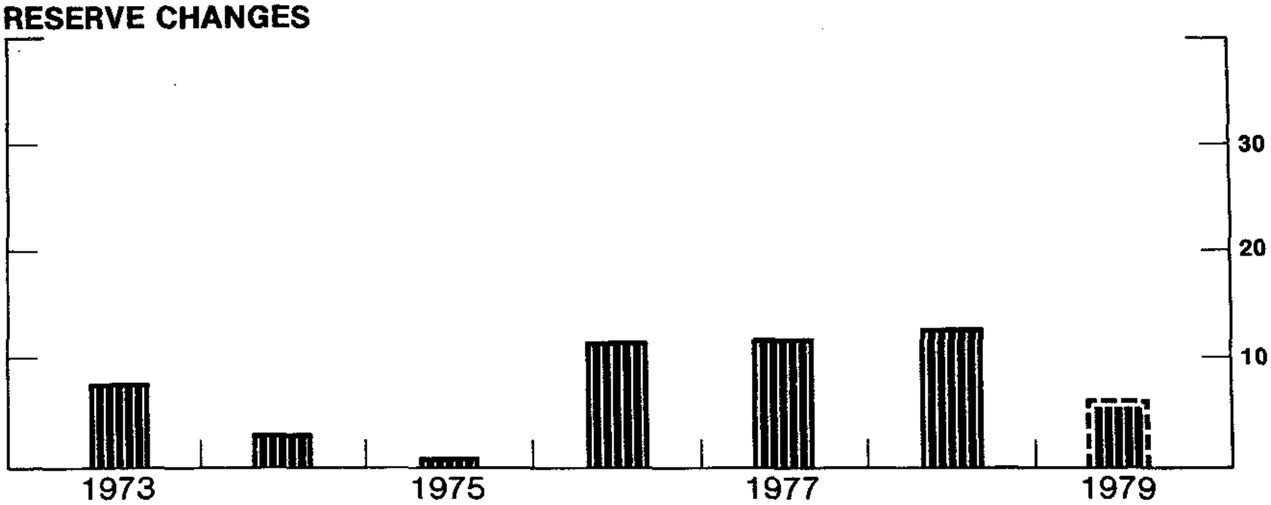


Table II

EXTERNAL DEBT OF NON-OIL DEVELOPING COUNTRIES
Billions of Dollars

	1973	1974	1975	1976	1977	1978	1979[e]
Total Debt[1/]	100	140	170	200	230	285	350
of which to banks[2/]	28	44	63	81	99	122	155
U. S. banks' share	54%	57%	54%	52%	48%	42%	39%
Foreign banks' share	46%	43%	46%	48%	52%	58%	61%

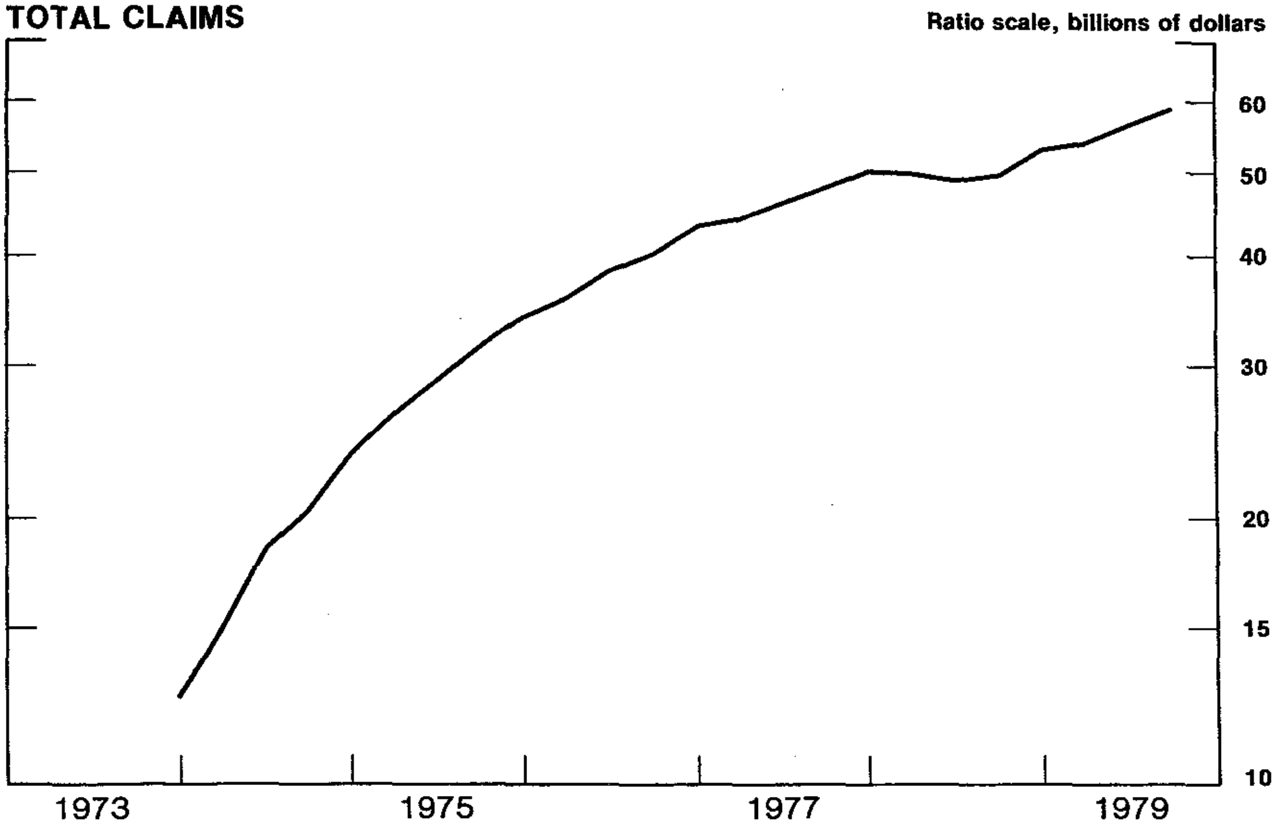
1/ Public long-term debt reported by the World Bank plus staff estimates of private long-term debt and short-term debt of developing countries other than offshore banking centers.

2/ Foreign claims of banking offices in major industrial countries and U. S. bank branches in offshore banking centers.

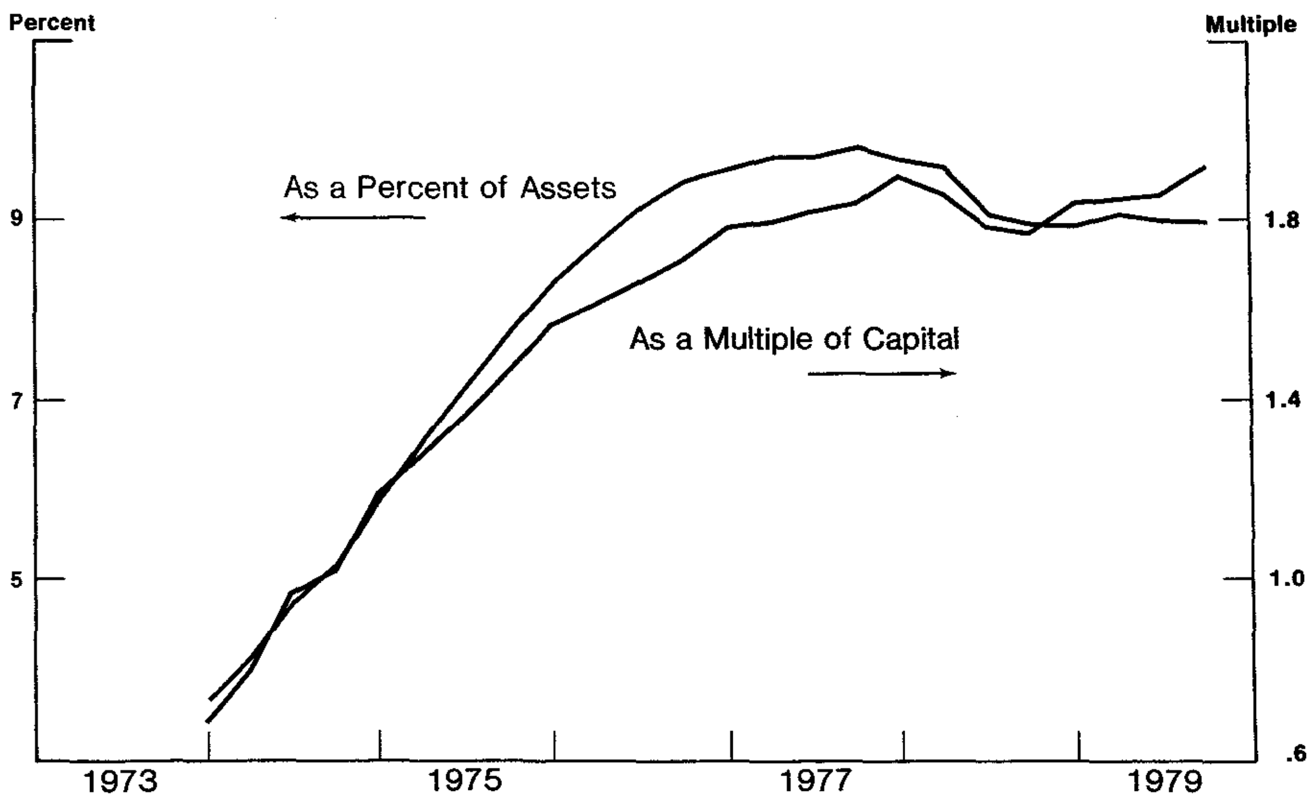
e = estimate

U.S. BANK CLAIMS ON NON-OIL DEVELOPING COUNTRIES

TOTAL CLAIMS



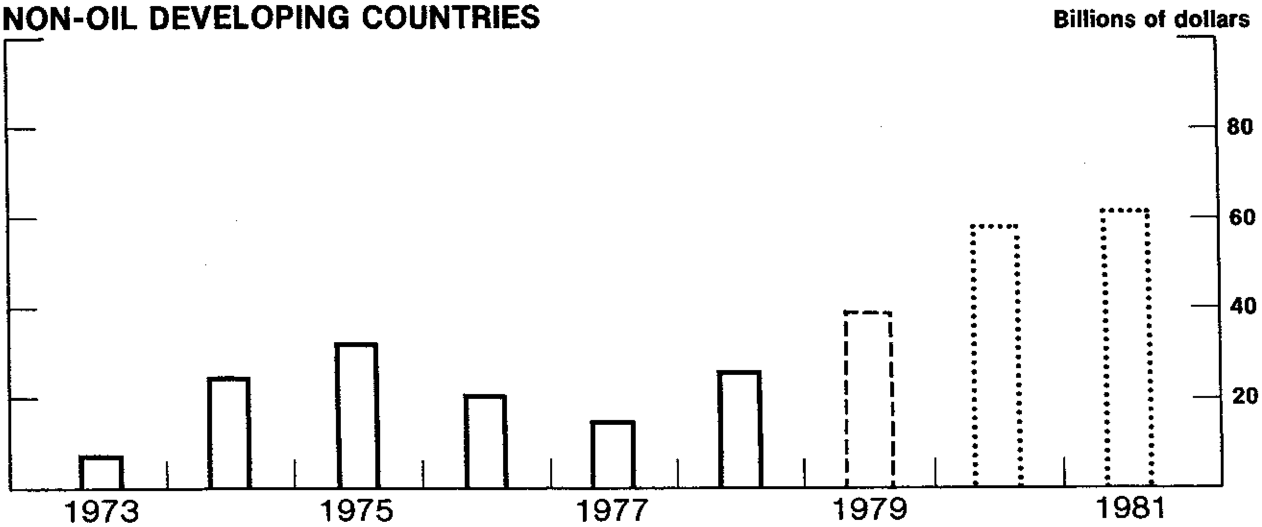
RELATIVE TO ASSETS AND CAPITAL*



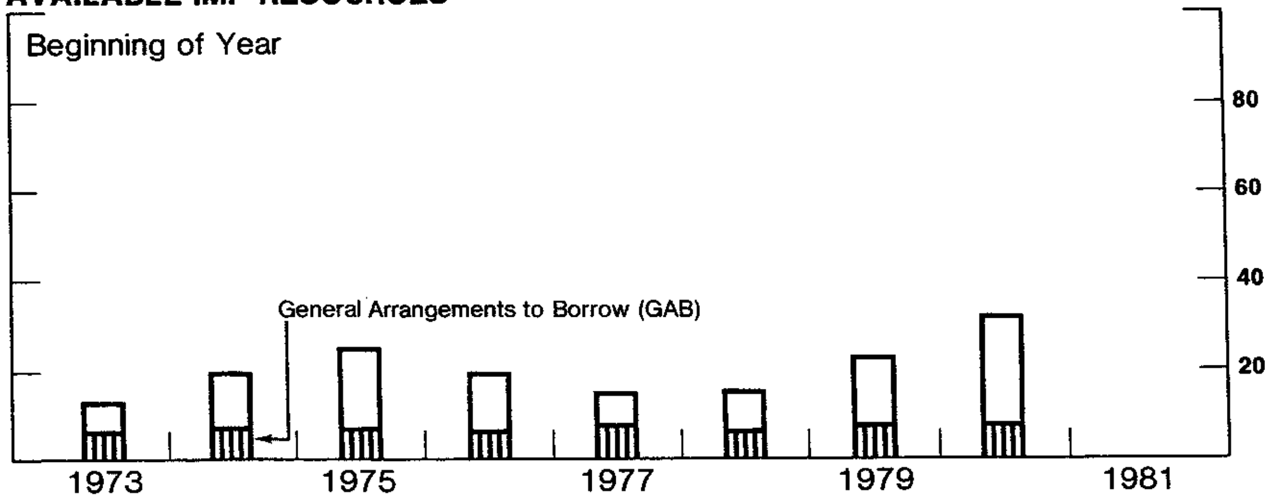
*Capital and assets data refer to 24 large banks that account for about five-sixths of U.S. bank lending to non-oil developing countries.

Chart 12

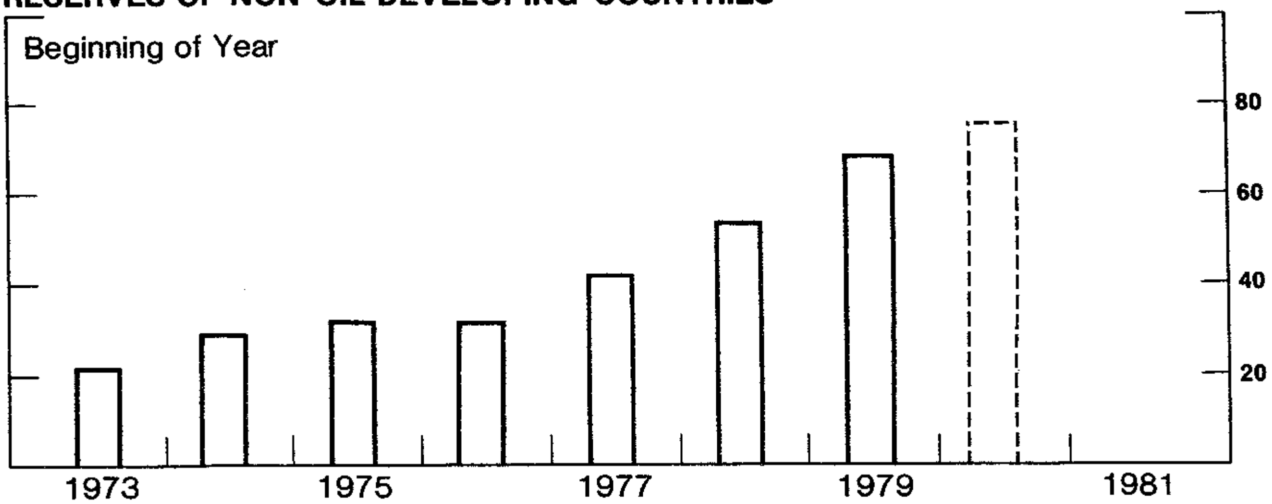
CURRENT ACCOUNT DEFICITS OF NON-OIL DEVELOPING COUNTRIES



AVAILABLE IMF RESOURCES



RESERVES OF NON-OIL DEVELOPING COUNTRIES



Notes for FOMC Meeting

February 4-5, 1980

Scott E. Pardee

Since the last meeting of the FOMC, the exchange markets for the dollar have been subject to several crosscurrents. For the United States, the economic fundamentals have, if anything, deteriorated. Our latest trade figures, a deficit of $3.1 billion for December, were a disappointment to the market. Earlier expectations of a swing into current account surplus in 1980 have pretty much been erased. A new round of oil price increases in currently under way, which will add further to our oil import bill. Also, many feel that the U.S. economy is likely to be more buoyant than previously expected. Exchange traders are particularly concerned that an increase in military expenditures in the United States, coupled with several types of election year budgetary largesse, will lead to much larger deficits this year and next than projected by the Administration.

Meanwhile, our inflation rate continues to be uncomfortably high, and hopes for early improvement have dimmed. So far the market's fears of a prolongation or intensification of inflation have not prompted renewed selling pressures on the dollar. Some market participants explain this in terms of the market's continuing positive reaction to the October 6 measures by the Federal Reserve and the System's follow-through on those measures. Interest rates have been high enough to protect the dollar from a build-up of speculative short positions, and coordinated intervention has spiked the few selling bouts which did occur.

At the same time, new interpretations of recent events have favored the dollar. Over the past three weeks, there have been no new surprises in Iran or new aggressive acts by the Soviet Union. The market's immediate concern over the implication of these problems for the dollar has begun to wane, and some traders are beginning to believe that the dollar will come out all right no matter what happens. A peaceful solution to Middle East tensions would favor the dollar. Intensification of the cold war would also help the dollar against the currencies of Western Europe and Japan. This concern has already prompted flows of funds out of Germany, out of marks, into the United States and into dollars. Whereas the mark had been bolstered in previous months by substantial diversification out of dollars by Iranian and other OPEC interests, the net flow into marks from those sources seems to have dried up and in some cases we have heard of some return flow into dollars. The peaking out of the gold price has also helped to relax tensions in the exchange markets for the dollar. Finally, the fact that Germany has swung into current account deficit has at long last caught the attention of foreign exchange traders, and the prospect of a continuing current account deficit for Germany in 1980 is considered negative for the mark.

On balance, over the past weeks the dollar has tended to firm against most major currencies. Since the last meeting the dollar has risen a net of 1-½ percent against the German mark. This is only 2-½ percent above the record low reached earlier this year, and 3 percent below the level reached at the time of the October 6 package. The dollar has firmed against other currencies as well. An exception is sterling, which continues to be underpinned by high interest rates in London and by the market's positive attitude toward the United Kingdom's self-sufficiency in oil. The Canadian dollar also has advanced relative to all currencies, largely on energy-related considerations.

In view of the continuing concern over the economic fundamentals for the United States, the recent firming trend for the dollar is not viewed as a major turnaround. But the uptick has been a welcome respite from the recurrent selling pressures over the last half of 1979.

During this period we intervened on four occasions, selling some $114 million worth of marks out of System and Treasury balances. Otherwise, we are able to take advantage of the large calendar of international borrowings in German marks, the proceeds of which are converted by the Bundesbank through its capital export conversion program. With marks offered to us by the Bundesbank, coupled with our purchases from other correspondents we repaid a total of $494 million of swap drawings on the Bundesbank, reducing the outstanding debt to $2.6 billion. We also repaid the latest $22 million of swap debt in Swiss francs. During the period, the Treasury issued a new Carter note in the amount of 2 billion marks, thereby rebuilding its cash resources in marks.

With the dollar firming over the last few days the Bundesbank has begun to make modest sales of dollars. Since last fall the Bundesbank had accumulated a substantial sum of dollars, from the U.S. military and interest earnings, which it has held off the market and it was only a matter of time before they began to release some of these dollars to the market. But Bundesbank officials are also candid in admitting that they do not want to see a sharp decline in the mark. These operations, while modest, risk the impression in the market that the authorities are trying to cap the exchange rate. The dollar's recovery still seems rather tenuous for us to enter a substantial program of mark purchases in the market, but we may share in some of the marks arising out of the Bundesbank's dollar sales.

FOMC MEETING
FEBRUARY 4-5, 1980

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Desk operations since the last meeting have been directed at providing reserves consistent with the monetary growth rates specified by the Committee from December to March--4 to 5 percent for M_1 and about 7 percent for M_2. Reserve paths for the four weeks ending February 6 envisaged a 5 percent growth rate for M_1 in January and a borrowing level around $1 billion. As of this point, it is estimated that total reserves for the four weeks may average a little below the path--by about $85 million. Nonborrowed reserves will be more substantially below their path, perhaps by some $300-400 million, while borrowing may average around $1.2 - 1.3 billion.

The modest shortfall in total reserves may have been about consistent with the slower-than-expected money growth that developed in the latter part of January. January M_1 growth is currently estimated at about a 1 1/2 percent annual rate (although M_{1A}, with its somewhat different make-up and revised seasonals that should apply to the old M_1 as well, may have grown at something like a 4.8 percent rate). M_2, on the old definition, grew at about a 5 1/4 percent annual rate. Apart from slower money growth, the shortfall in total reserves could also be traced in some measure to the behavior of market factors--notably a particularly large shortfall in reserves on the last day of the January 30 statement week.

The higher-than-expected level of discount window borrowing seems to have reflected a greater-than-anticipated propensity to borrow rather than unwarranted firmness in monetary conditions. As we saw the higher borrowing emerge we sought to provide nonborrowed reserves more readily in the early parts of statement weeks, and thus relieve the need for borrowing--although we sometimes drained reserves late in the week once the high borrowing had already occurred, since otherwise it was expected that total reserves would come out well above path.

In this final week, borrowing is running a bit lighter than it did in earlier weeks of the interval, averaging about $960 million through Sunday compared with an average of $1.4 billion in the first three weeks since the last meeting. Meantime, the money market has eased off a bit as the intermeeting period progressed, with the average weekly funds rate working down from around 13 7/8 percent to about 13 3/8 or 13 1/2 percent in recent days.

In outright operations during the interval, the System sold or redeemed about $2.5 billion of Treasury bills--responding to the seasonal provision of reserves chiefly caused by the post-Christmas currency reflow. The total includes $200 million of bills scheduled to be redeemed next Thursday as a result of bids in yesterday's auction. Outright operations included the sale of about $900 million of bills in the market in mid-January. The need to absorb reserves might have been even greater but for some large declines in float in January, which may have reflected improved check transportation efforts as well as milder weather. Matched sales purchase transactions were employed daily with foreign accounts and on a few occasions in the market, while System repurchase agreements were used on a few days in late January to make short-term reserve adjustments.

While speaking of Desk operations, I should mention, with an apology, that at the last meeting I understated the net increase in outright System holdings of Government and agency securities during the full year 1979. The increase was about $10.3 billion on a commitment basis, not $7.2 billion--the error reflecting a misunderstanding in the treatment of holdings reduced temporarily by matched-sale purchase transactions. The increase included $6.2 billion of bills, $3.7 billion in Treasury coupon issues and $.3 billion of agency issues.

In contrast to the slightly lower Federal funds rate, most market interest rates rose during the past month, with the larger increases occurring among longer maturities. This unusual pattern, which saw some long Treasury bond prices drop as much as 7 to 9 points and long yields rise as much as 90 to 110 basis points, reflected a shift in sentiment on the business outlook, and a weakening in confidence that the long-term inflation problem can be handled successfully. Not only were the late 1979 business data stronger than expected, but also the intensifying Middle East problem and related prospects for a stronger defense build-up lent credence to those who now see the widely anticipated recession as increasingly unlikely. Expectations of a heavier corporate financing calendar have added to market pressures. In the recent market mood, the President's Budget message was greeted with skepticism in the financial community, as they expect larger Treasury demands on the market than the official numbers suggest. The rise in unemployment reported last Friday, while long-expected, was shrugged off. Nor did the market draw satisfaction from the recent money supply weakness, as there is concern that the newly defined money measures may tell a different story. There is also a feeling that the System has relaxed its firm resolve of last October to exercise restraint. Most of these factors would tend to raise yields in all maturities, but the particularly severe adjustment at the long end seems to reflect deep discouragement about prospects for dealing successfully with inflation. Time and again one hears from the market that many traditional long-term investors are reluctant to commit funds for an extended period.

For intermediate-term Treasury issues the yield increases in the past month have been about 65 to 90 basis points, and for shorter coupon issues the rise is about 20 - 60 basis points. Dealers have kept their inventories of coupon issues light except for underwriting new issues. The market will bid tomorrow for $3 1/4 billion of 3 1/2 year notes, with the rate expected to be around 11 1/2 percent. Wednesday is the auction of $2 billion 7 1/4 year notes and Thursday $2 billion of 30-year bonds, with yields well above 11 percent expected on both.

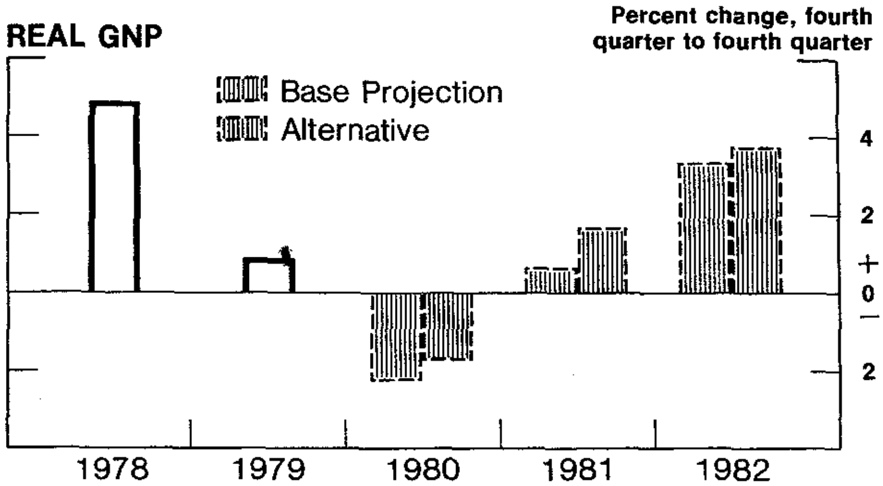
By comparison with the coupon area, most bill yields rose only moderately over the past month. Today's average 3- and 6-month rates of about 12.09 and 11.99 percent compared with about 11.94 and 11.85 percent just before the last meeting.

COMPARISON OF STAFF AND ADMINISTRATION ECONOMIC FORECASTS

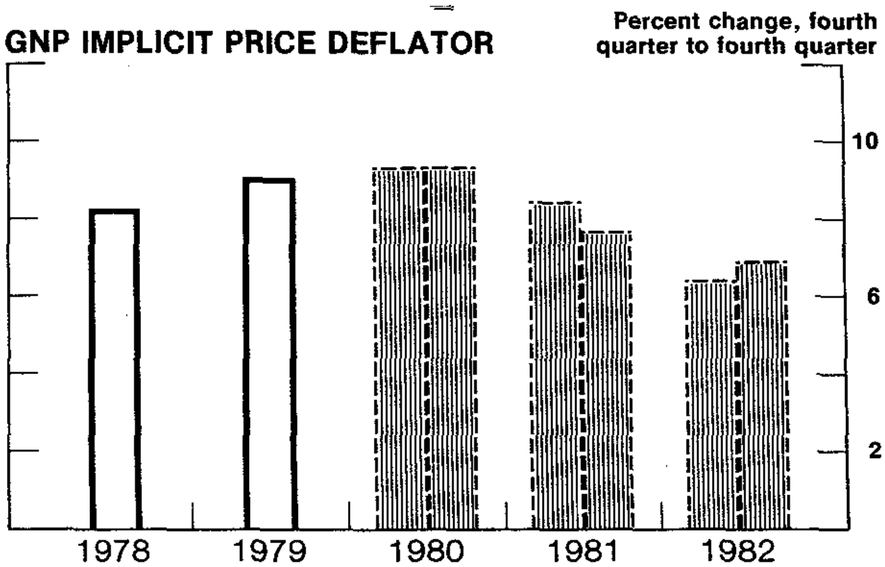
	1980		1981	
	Staff	Administration	Staff	Administration
NOMINAL GNP Percent change, Q4 to Q4	7.0	7.9	9.0	11.7
REAL GNP Percent change, Q4 to Q4	−2.2	−1.0	0.6	2.8
GNP IMPLICIT DEFLATOR Percent change, Q4 to Q4	9.3	9.0	8.4	8.6
UNEMPLOYMENT RATE Q4 level, percent	7¾	7½	8¾	7¼

FISCAL ALTERNATIVE—TAX CUT*

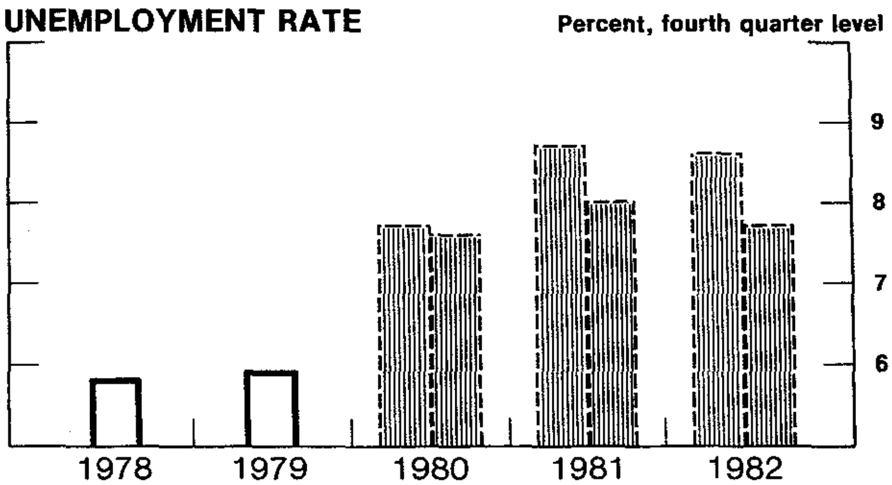
REAL GNP



GNP IMPLICIT PRICE DEFLATOR

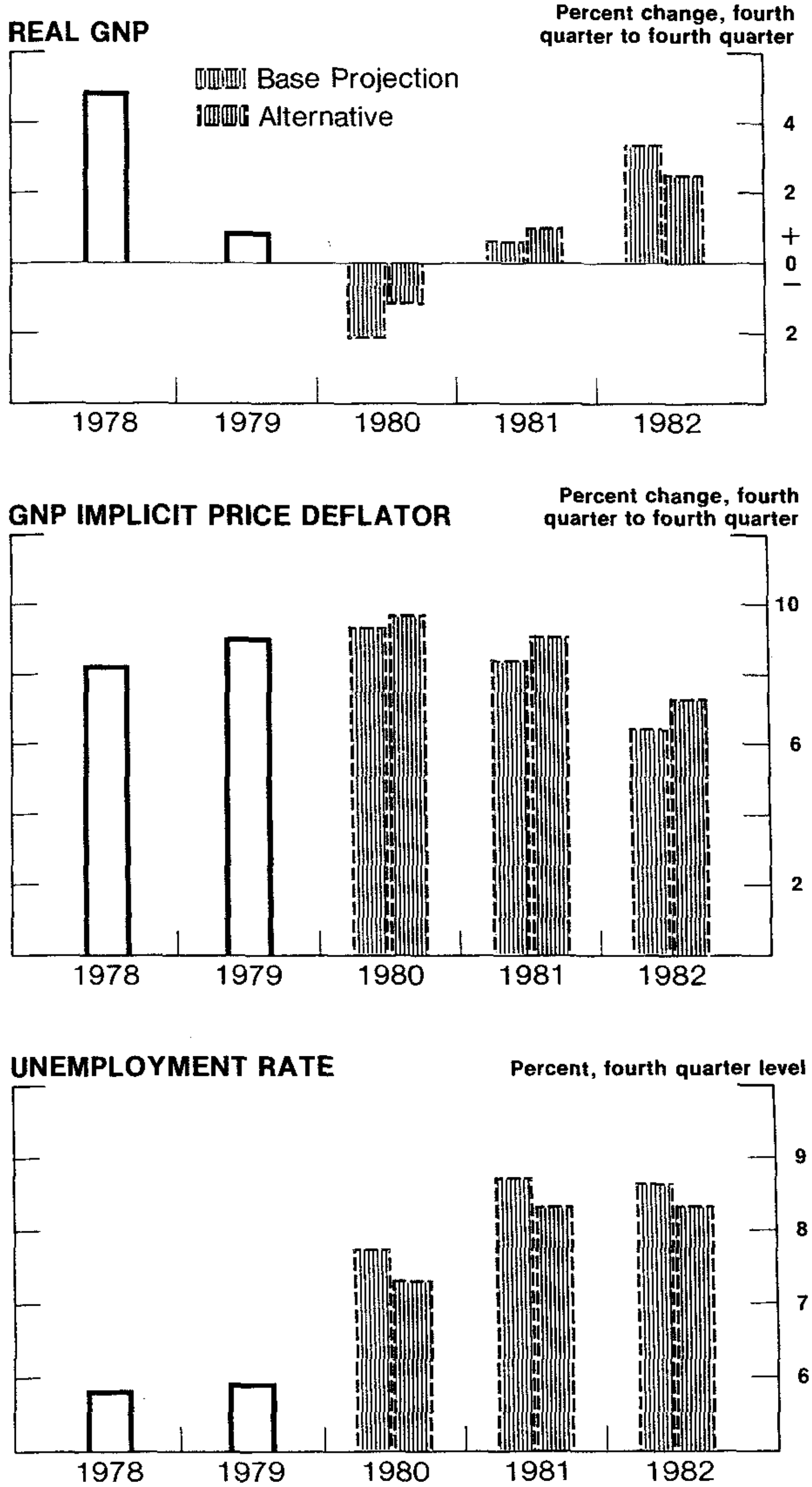


UNEMPLOYMENT RATE

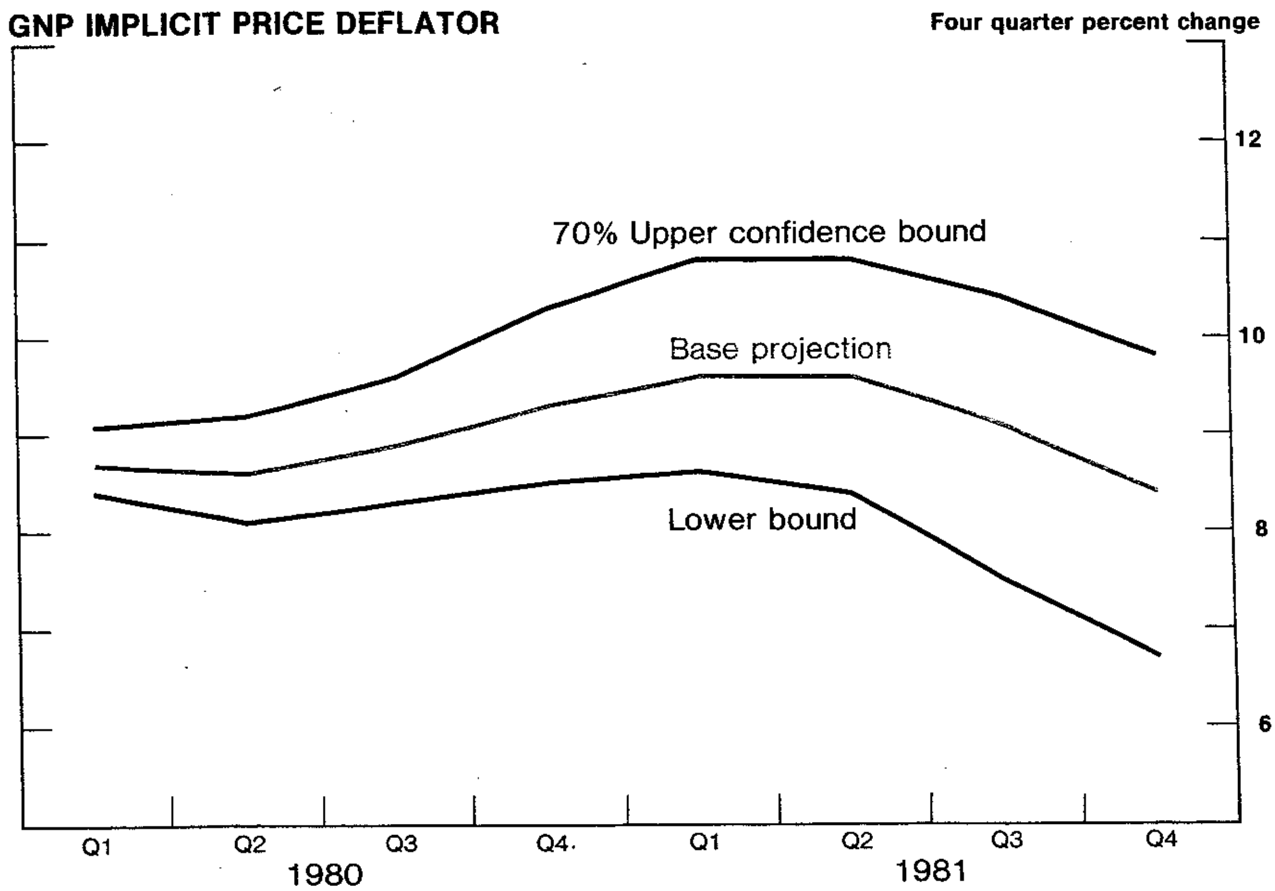


*Consists of:
- $10 billion cut in personal taxes mid-1980
- $10 billion cut in corporate taxes mid-1980
- Partial rollback of social security tax increases scheduled January 1981 ($13 billion)

FISCAL ALTERNATIVE—DEFENSE SPENDING*



*Defense purchases exceed those in the base projection by $10 billion during 1980, $20 billion in 1981, and $20 billion in 1982.


GNP IMPLICIT PRICE DEFLATOR
Four quarter percent change
12
10
8
6
70% Upper confidence bound
Base projection
Lower bound
Q1
Q2
Q3
Q4
Q1
Q2
Q3
Q4
1980
1981

James L. Kichline
February 5, 1980

FOMC CHART SHOW -- INTRODUCTION

During our presentations this morning we will be referring to the package of charts distributed to you. The first chart in the package displays the principal policy assumptions underlying the staff forecast presented in detail in the Greenbook. For monetary policy, growth of M-1A is assumed at 5 percent in 1980 and 1981, around the preferences generally expressed at the Committee's January meeting, and less than had been assumed in earlier staff forecasts. For fiscal policy, we have made some adjustments in expenditures in response to newly available information, including the President's budget proposals. The forecast assumes no discretionary tax changes which is consistent with the current posture of the administration. Energy prices are assumed to continue rising rapidly, with oil import prices going up nearly one-third this year and further next year. Domestic crude oil prices will be rising faster than imported crude prices because of the decontrol program which will permit all domestic crude to move to world prices by the fourth quarter of 1981.

Both monetary and fiscal policy assumptions are interpreted as relatively restrictive over the forecast horizon in comparison with past cyclical experience. The top panel of the next chart shows the decelerating rate of growth of M-1A and M-1B built into the forecast; M-1A in fact understates growth of transactions balances in 1979 because of shifts into ATS and New York NOWs. Taking account of this, growth of M-1A slows from around 6-3/4 percent in 1979 to 5 percent. Consistent with the GNP outlook, holding M-1A to 5 percent is expected to result in a drifting down of interest rates--the lower panel--to around 11 percent for 3-month bills later this year, before moving up somewhat in 1981.

The top panel of the next chart compares the administration and staff federal budget outlooks. In fiscal 1980 outlays, receipts, and the deficit are not appreciably different in the aggregate, although we have assumed a somewhat different composition of expenditures--such as more spending for defense and less for the strategic petroleum reserve. For fiscal 1981, however, there are considerable differences related to the underlying economic outlook and other items which result in a staff budget deficit estimated at $39 billion, well above the administration's $16 billion figure. The widening deficit reflects the effects of automatic stabilizers; discretionary fiscal policy is continuing to move in a restraining fashion as illustrated in the bottom panel. On a high employment basis the budget moves toward restraint in 1980 and markedly so in 1981. Much of the growth in the high employment surplus in 1981 comes from social security tax increases, the windfall profits tax, and the impact of inflation on tax revenues.

The next chart shows several indicators of economic activity. Total industrial production--the top left panel--moved sideways throughout much of last year, as substantial declines in the output of motor vehicles and parts were offset by increases in production of business equipment, consumer nondurable goods, and defense items. Nonfarm employment continued to grow at a good clip in 1979, outpacing growth in economic activity. Employment growth last month--not shown on the chart--continued large but there were also signs of weakness as layoffs mounted and the unemployment rate rose 0.3 percentage point to 6.2 percent. Retail sales in real terms also have shown signs of weakening following a surge late in the summer--owing mainly to enlarged purchases of autos along with furniture and appliances. In the housing market, starts fell last quarter. All told, real GNP last quarter is estimated to have increased at a 1-1/2 percent annual rate, with greater evidence of weakness in activity in several sectors.

Mr. Zeisel will continue the presentation with an analysis of domestic nonfinancial developments and prospects.

Joseph S. Ziesel

February 5, 1980

FOMC CHART SHOW

Recent developments continue to suggest to the staff that fundamental forces are moving us into recession. Given the momentum evident at year-end we expect at most only a modest contraction in the current quarter. But, as portrayed in the first chart, we do project a progressive weakening of activity later this year lasting into early '81. Recovery is projected to begin in the spring of '81, but for the year as a whole real GNP in expected to rise by only about ½ percent. From peak to trough, this projected contraction totals about 2 ½ percent; it falls in the middle of the range of postwar recessions in terms of severity--or about half the decline that occurred in 1974-75 when inventories were grossly out of line with sales--which is not the case today.

The consumer has played a key role in supporting activity recently, and, as is evident in the top panel of the next chart, this was accomplished in the face of virtual cessation of growth of real disposable personal income. The strength of consumer demand in the second half of 1979 appeared to represent spending to maintain normal growth of living standards in an inflationary environment and the purchase of durable goods in anticipation of continued rapid price increase. As may be seen in the middle and lower panels of the chart, this increased spending was associated with a sizable decline in the saving rate--one of the sharpest drops in the postwar years--while at the same time consumers took on historically large debt burdens.

While it has been extremely difficult to anticipate accurately consumer behavior recently, consumer spending propensities would appear to be vulnerable to any further weakening in real income growth, given debt burdens and low saving rates. And, as is evident in the top panel of the next chart, just such a decline in real income appears to be in prospect. Although employment gains have slowed this past year, the growth of jobs has been out-running production advances, and some downward employment adjustments are long overdue. If these occur, as we expect, in conjunction with continued sharply rising prices, it seems very likely that 1980 will witness a decline of real disposable income. After-tax income will be cut further by a large increase in social security taxes scheduled for the beginning of 1981.

While it is possible that consumers will continue to strive to maintain living standards, the Michigan survey suggests that the public has recently moved away somewhat from the buy-in-advance-of-inflation rationale that seemed to have bolstered durable goods purchases. And, as is evident in the middle panel, income otherwise available for the purchase of luxuries is increasingly being absorbed by skyrocketing energy prices. As the bottom panel indicates, these various factors have led us to expect a very sluggish outlook for real consumer demand--a decline in 1980 and very little change in 1981.

Housing is also likely to continue to be a negative factor in overall growth, particularly during the next few quarters. As is evident in the top panel of the next chart, deposit growth at thrift institutions weakened further following the Fed's October 6 policy actions. In conjunction with high interest rates, this has led to a sharp reduction in outstanding mortgage lending commitments--the lower panel. While the supply of funds from sources such as housing bonds and mortgage passthroughs should cushion the housing decline, demand factors are also expected to be a major influence damping construction activity this year. The top panels of the next chart give dramatic evidence of the weakening of demand recently. Sales of new homes have fallen substantially since last fall and the average price of new homes has declined sharply; such a decline in prices, if sustained, could well blunt the investment motive for purchasing single-family homes and condos.

As indicated in the bottom panel, we are now forecasting housing starts to drop to a 1.4 million annual rate in the first half of this year. Starts are expected to turn up by the fall, as activity benefits from some easing in mortgage rates which will permit an emergence of underlying demand associated with population and migration trends.

Turning to the business sector, the top panel of the next chart indicates the recent trend in real orders for capital equipment. While new orders have edged up in the past few months, their level remains below that of the first quarter. These figures foretell weaker growth in business fixed investment. They are generally consistent with the results of the latest plant and equipment survey, which shows an increase of only about 1 percent in real terms for 1980 as a whole--and implies a downturn later this year.

The outlook for capital spending in 1981 is obviously more uncertain. But as indicated in the middle panel, we are projecting a further drop in capacity utilization rates in manufacturing as markets weaken, leading to reduced pressure for expansion of capital stock, particularly given poorer profit performance and continued high normal interest rates. As the bottom panel shows, we thus foresee a continued, although far from precipitous, decline in real capital outlays through much of next year.

The rate of inventory investment over the next two years is expected to reflect largely developments in fixed capital spending and other final demands. As is indicated in the top panel of the next chart, the deterioration of auto demand in the spring of 1979 resulted in a backup of dealers' stocks of large, less fuel-efficient cars, but a combination of production adjustments and price-cutting eased that problem considerably. As shown in the middle panel, by the fall overall business inventory/sales ratios were almost back to levels of 1977 and 1978. We anticipate that businessmen will continue to keep stocks generally in line with sales. As is evident in the bottom panel, this implies some liquidation of stocks from mid-1980 through early 1981. A recovery in stock building should get under way later in 1981 as aggregate sales pick up. Throughout the forecast period we have allowed for some inventory accumulation in line with the rise in defense spending that now appears in process.

The pickup now scheduled in 1980 and 1981 for federal defense spending, other than personnel compensation, is portrayed in the top panel of the next chart. In real terms we now anticipate a rise in these defense purchases of about 7 percent in both the current and coming fiscal years--much more than in the last five years. All of the expected increase will be in procurement, operations, and research. Our figures are slightly larger than those in the Administration's budget and give additional upward thrust to total federal spending. But the overall rise in government purchases is projected to be blunted somewhat by continued restraint in nondefense outlays. Moreover, we anticipate that increases in federal spending will be offset by reduced real outlays at the state and local level as these jurisdictions respond to high interest rates and a squeeze on receipts. Thus, as is portrayed in the middle panel, in aggregate real government purchases of goods and services are expected to increase only a little faster in the next two years than last year. Nevertheless, as a share of GNP, these figures do rise in '80 and '81, reversing the downtrend in this ratio that has been evident for five years.

The top panel of the next chart portrays the projected contraction in real nonfarm output and the associated employment adjustment. As is evident, employment gains in 1979--while smaller than in previous years--were dramatically out of line with the fractional rise in nonfarm output. It seems reasonable to assume that some of this "hoarded" labor will be disgorged in the near future as businessmen recognize that output is not rising rapidly enough to justify their retention. We are forecasting a decline of about 1-½ million nonfarm jobs from peak to trough, with the impact greatest in durables manufacturing.

We are also projecting a slower growth of the labor force--the middle panel--reflecting mainly poorer job prospects. But the unemployment rate--shown in the bottom panel--is projected to move up fairly sharply this year to about 7-¾ percent by the fourth quarter, and to drift up further during 1981, reaching 8-¾ percent by the end of the next year.

Rising unemployment can be expected to result in some damping of wage pressures, but labor costs nonetheless are likely to continue rising rapidly in the near term, for several reasons. First, as is evident in the top panel of the next chart, growth of compensation in 1979 fell sharply behind the rise in consumer prices. This should lead to attempts at wage catch-up in the latter half of 1981. And of course, the feedback effects of earlier energy price increases on wages and other costs will still be fueling inflation. We are assuming that food prices will move about in line with other prices over the next two years.

Finally, the next chart shows our current view of the outlook for overall inflation. On balance, we expect that the combination of a protracted period of slack markets, some improvement in productivity, and a moderation in the upward trend of energy prices will ease the inflation situation somewhat in late 1980 and in 1981. We are projecting overall prices to be rising at about an 8 percent rate by the end of 1981.

Mr. Truman will continue with a review of the international part of the projection.

CHART SHOW PRESENTATION
E.M. Truman
February 5, 1980

The upper left hand panel of the first international chart illustrates the dramatic shift over the past year in the cyclical situation of the United States relative to foreign industrial countries. The line shows the ratio of U.S. real GNP to the average of real GNP in other G-10 countries and Switzerland. Over the past four quarters, U.S. real GNP has expanded at about a 1 percent rate and foreign real GNP rose by about 3-1/2 percent. During 1980, while U.S. real GNP is expected to decline--as Mr. Zeisel has explained--foreign growth is expected only to moderate to about 1 percent. During 1981, foreign growth is expected to pick up and be about 2 percent faster than U.S. growth. These cyclical factors, along with oil, dominate our projection of U.S. international transactions.

As is shown in the upper right hand panel, the volume of non-oil imports is expected to decline this quarter. The decline continues through the first quarter of 1981 and then is reversed later next year. Because of rising import prices, the value of non-oil imports declines less in 1980 and later rises more rapidly.

The lower left hand panel indicates that the volume of non-agricultural exports is expected to expand much more moderately over the forecast period than has been the case for the past two years. Again, however, inflation imparts a big boost to the value of these exports.

The lower right hand panel presents our outlook for oil imports. Sharply higher oil prices--as described by Mr. Kichline--and weak U.S.

activity should produce a cutback in the volume of oil imports, but the higher prices will raise the value of oil imports to $90 billion, at an annual rate, by the end of 1981.

The second chart summarizes our external projection. The top panel shows that we expect a sharp increase in our trade and current account deficits this quarter as the result of lost grain and gold exports and because of higher oil prices. Thereafter, cyclical conditions predominate, pushing the current account into significant surplus by the fourth quarter of this year.

In terms of the GNP accounts, illustrated in the last two panels, real exports of goods and services are expected to decline slightly in 1980 reflecting lower agricultural exports and reduced service receipts. During 1981, we expect real exports of goods and services, on a GNP basis, to expand quite slowly, though somewhat faster than the rest of the economy. Thus, the rise in real GNP net exports of goods and services, depicted in the bottom panel by the red line, reflects mainly the cyclical decline in real imports of goods and services throughout most of the projection period.

Mr. Kichline will now complete our presentation.

James L. Kichline
February 5, 1980

FOMC CHART SHOW -- CONCLUSION

The first chart in the final section of your packet shows the volume of funds raised by nonfinancial sectors. Total funds raised declined last year from their peak in 1978 despite 10 percent growth of nominal GNP; the drop in the total reflected smaller federal government net financing while private borrowing was essentially unchanged for the year. Late in the year, however, private borrowing did drop off and we expect both demand and supply side constraints to result in a lower level of funds raised in 1980 than last year and little growth in 1981. Total funds raised relative to GNP, the lower panel, declined nearly 3 percentage points last year and is projected to decline further over the forecast horizon. A drop in this ratio is characteristic of recessionary periods.

The top panel of the next chart shows that reduced borrowing by households contributed appreciably to a recent reduction of private credit demands. Household borrowing declined in the second half of last year as both mortgage and other borrowing slackened--reflecting the reduced pace of spending on consumer durables and a slower pace of real estate activity. Household borrowing is projected to trend lower this year and to turn up a little in 1981 as activity recovers.

Total borrowing by nonfinancial corporations, the lower panel, also moved lower in the second half of last year and is expected to remain well below the early 1979 peak through 1981. External financing needs are projected to be held down by the sluggish growth of capital expenditures and little, if any, inventory accumulation. At the same time corporate financial positions are likely to remain tight in the aggregate, with a need to fund some of the large volume of short-term debt taken on in the past few years. However, double-digit long-term rates may well act to restrain a major move into permanent financing.

The next table provides a comparison of the staff and administration economic forecasts. In 1980 the forecasts are not greatly different, and well within the range of uncertainty associated with point estimates. For 1981, however, the administration is forecasting considerably larger expansion of nominal GNP stemming from a faster economic recovery; prices are projected to rise about the same as in the staff forecast while the unemployment rate is 1-1/2 percentage points lower. The strong performance of real GNP seems to arise out of a higher pattern of consumer expenditures related in part to a savings rate that remains rather low. In addition, financial conditions implicitly are a good deal easier--the bill rate is assumed to fall more than 2 percentage points by the summer and by another 1 percentage point a year later. Irrespective of the monetary assumptions, however, experiments with the quarterly econometric model suggest there is a reasonable chance of hitting the administration inflation forecast, but a very low probability of obtaining or bettering both the inflation and the unemployment goals of the administration in 1981.

These experiments with the econometric model provide a formal way of assessing the uncertainty associated with a given forecast and are based upon errors in the equations of the model. But uncertainty may arise from the policy assumptions as well. In the current situation a good deal of uncertainty attaches to the fiscal assumptions. The next chart indicates the results derived from a fiscal alternative involving a tax cut. The tax cut provides a spur to real GNP growth in 1980 through 1982 compared to the base projection, and carries with it a lower unemployment rate--the bottom panel. In 1981 the rate of increase of the deflator is also lower, reflecting the effects of the assumed partial rollback of social security tax increases, but prices in 1982 once again are rising faster owing to the higher level of activity. A cut in social security taxes alone would provide less impetus to real activity and employment growth but would carry with it a reduction in the price level from what would prevail otherwise.

The next chart shows the results of a different fiscal alternative involving appreciably more defense spending than in the base projection. The projected outcome involves more real GNP in 1980 and 1981 than in the base projection but more inflation as well. By 1982, however, real GNP expansion falls below that in the base projection as holding to a 5 percent money growth with accelerating inflation produces higher interest rates and begins choking off activity. Such an alternative is likely to have even larger effects than produced by the econometric model since rapid defense increases undoubtedly would affect business and consumer attitudes as well as result in bottlenecks that would intensify inflationary pressures.

None of these alternatives suggests an outcome that is particularly encouraging in the short- and medium-term. The last chart in the package indicates that the deeply ingrained inflation and inflationary expectations are the nub of the problem. Adapting the base projection to the econometric model provides an estimate of the range of uncertainty around the price forecast. As indicated, by the fourth quarter of 1981 there is a 70 percent probability that prices will be rising somewhere between 9-3/4 and 6-3/4 percent; alternatively expressed there is only a 15 percent chance that inflation will be less than the 6-3/4 percent lower bound at that time. These probabilities of course would change to the extent that, for example, a mandatory wage-price control program is instituted or wage and price expectations are formed in ways different from past experience. But, judging from history, the likelihood of achieving both attractive inflation and unemployment outcomes in the shorter run does not seem high given the structure of the economy.

CONFIDENTIAL (FR) CLASS II-FOMC

Material for

Staff Presentation to the Federal Open Market Committee

February 5, 1980

PRINCIPAL ASSUMPTIONS

MONETARY POLICY

- Growth of M-1A averages 5 percent in 1980 and 1981

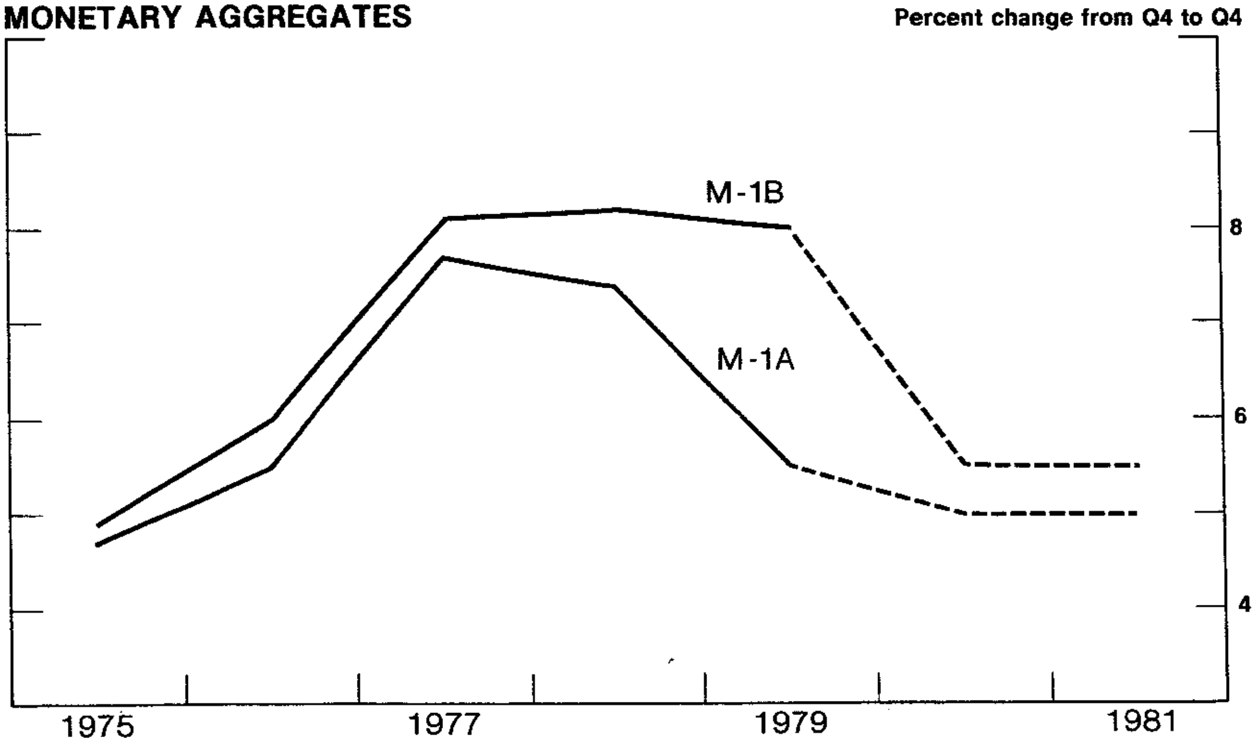
FISCAL POLICY

- Unified budget expenditures of $563 billion in FY 1980 and $623 billion in FY 1981
- No discretionary tax changes during forecast period

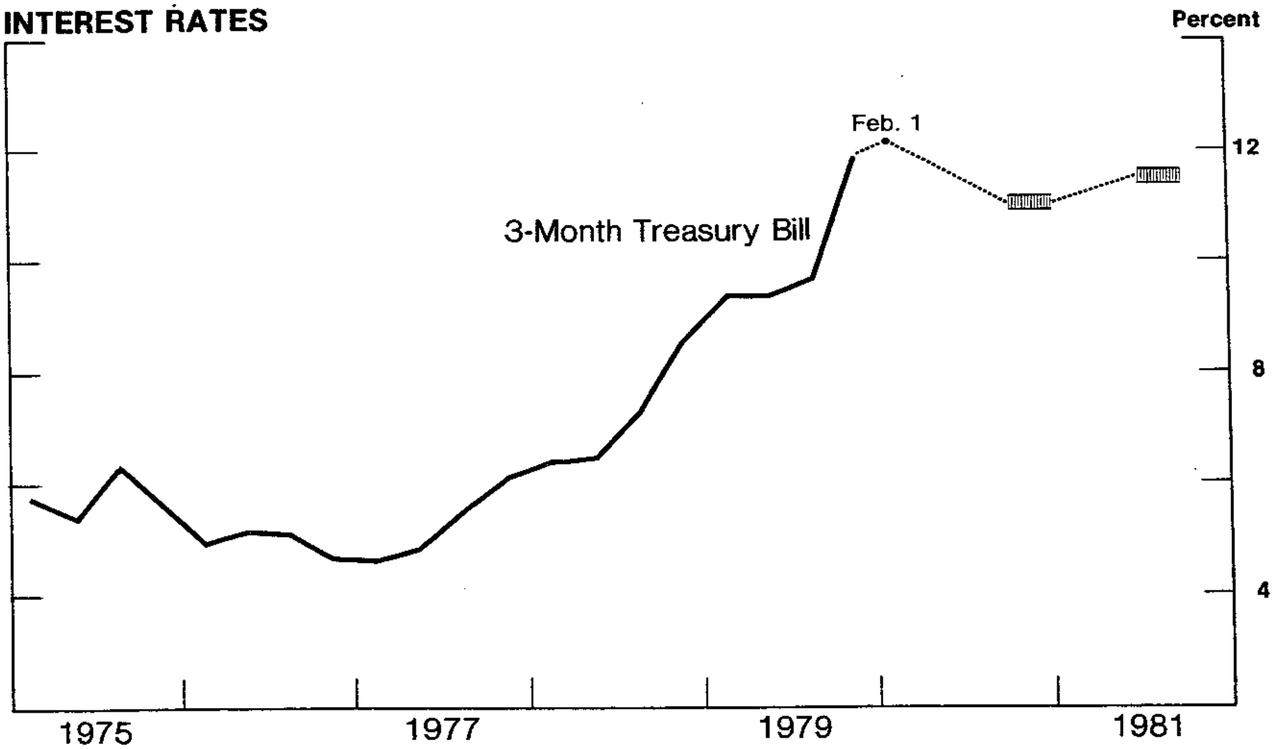
ENERGY PRICES

- Oil import prices rise 32 percent during 1980 and 13 percent during 1981
- Decontrol of domestic crude oil prices continues as scheduled

MONETARY AGGREGATES



INTEREST RATES



FEDERAL BUDGET

Billions of dollars

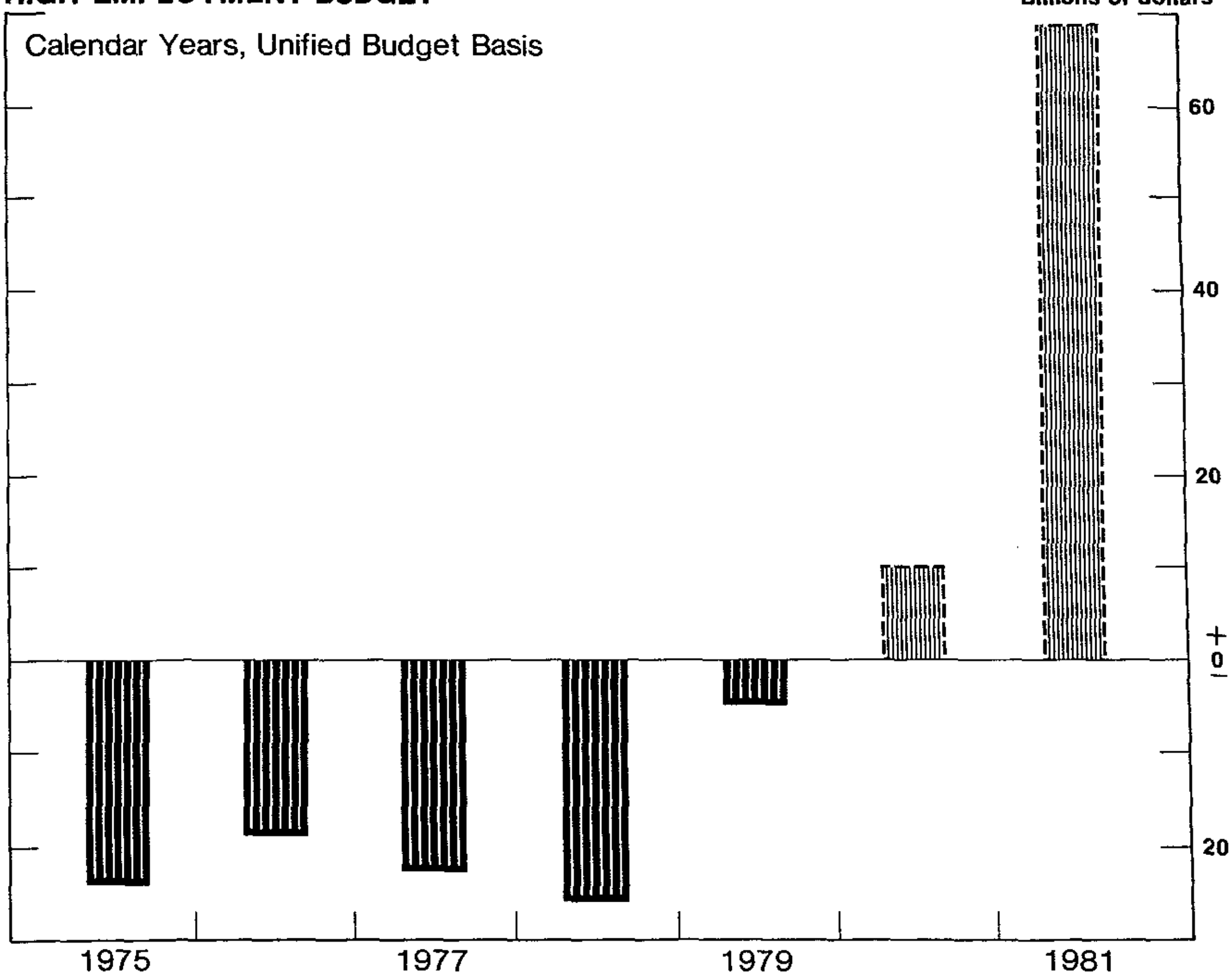
Fiscal Years, Unified Budget Basis

	1979	1980		1981	
	Actual	Admin.	FRB	Admin.	FRB
Outlays	494	564	563	616	623
Receipts	466	524	520	600	584
Deficit	28	40	43	16	39

HIGH-EMPLOYMENT BUDGET

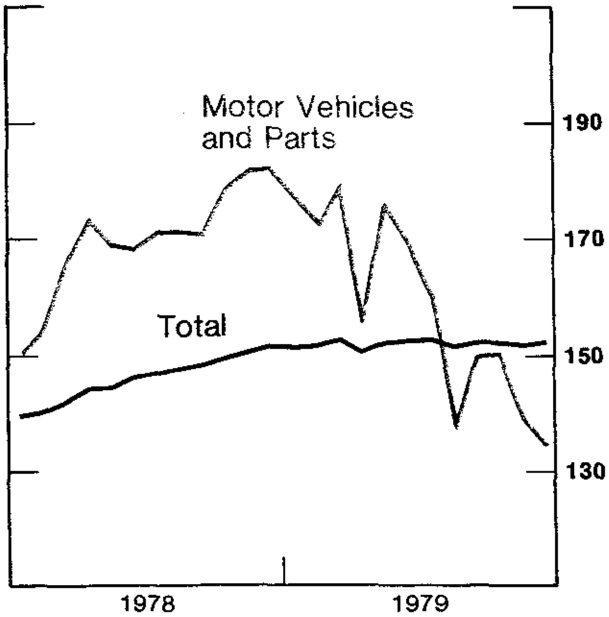
Billions of dollars

Calendar Years, Unified Budget Basis

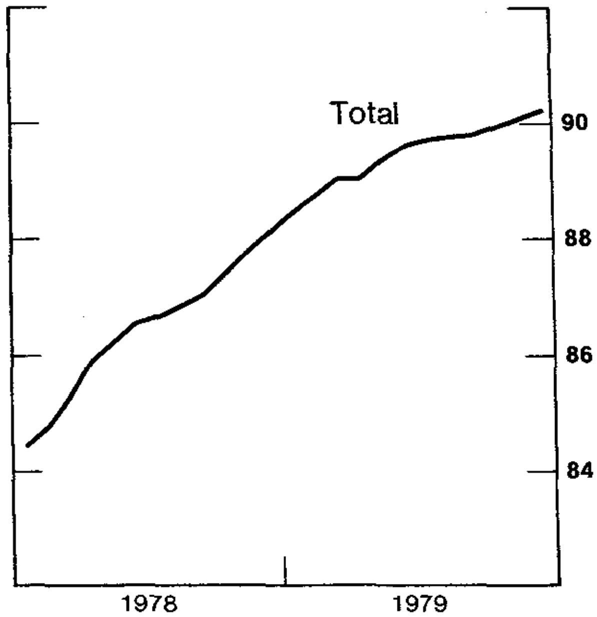


ECONOMIC ACTIVITY

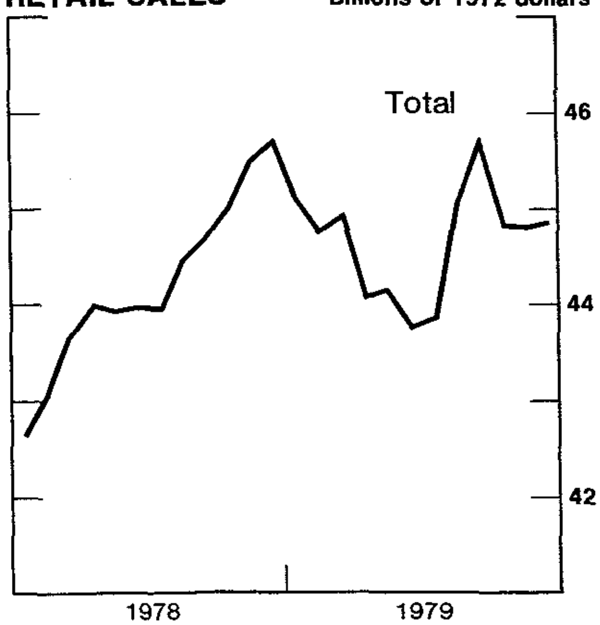
INDUSTRIAL PRODUCTION



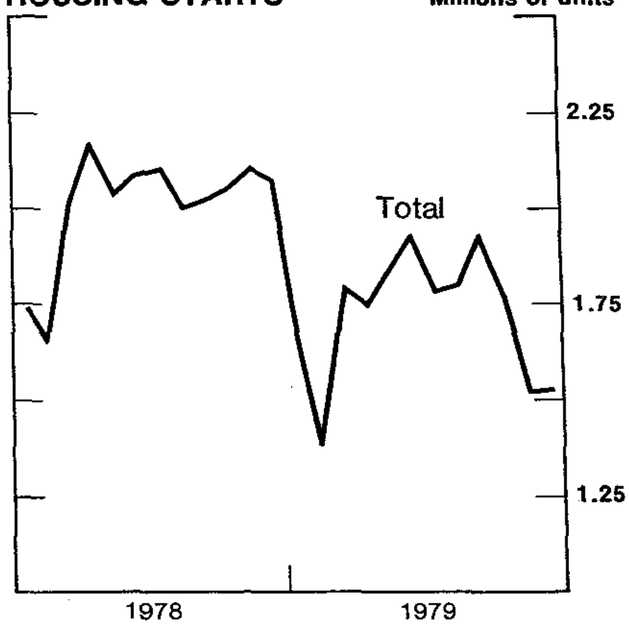
NONFARM EMPLOYMENT

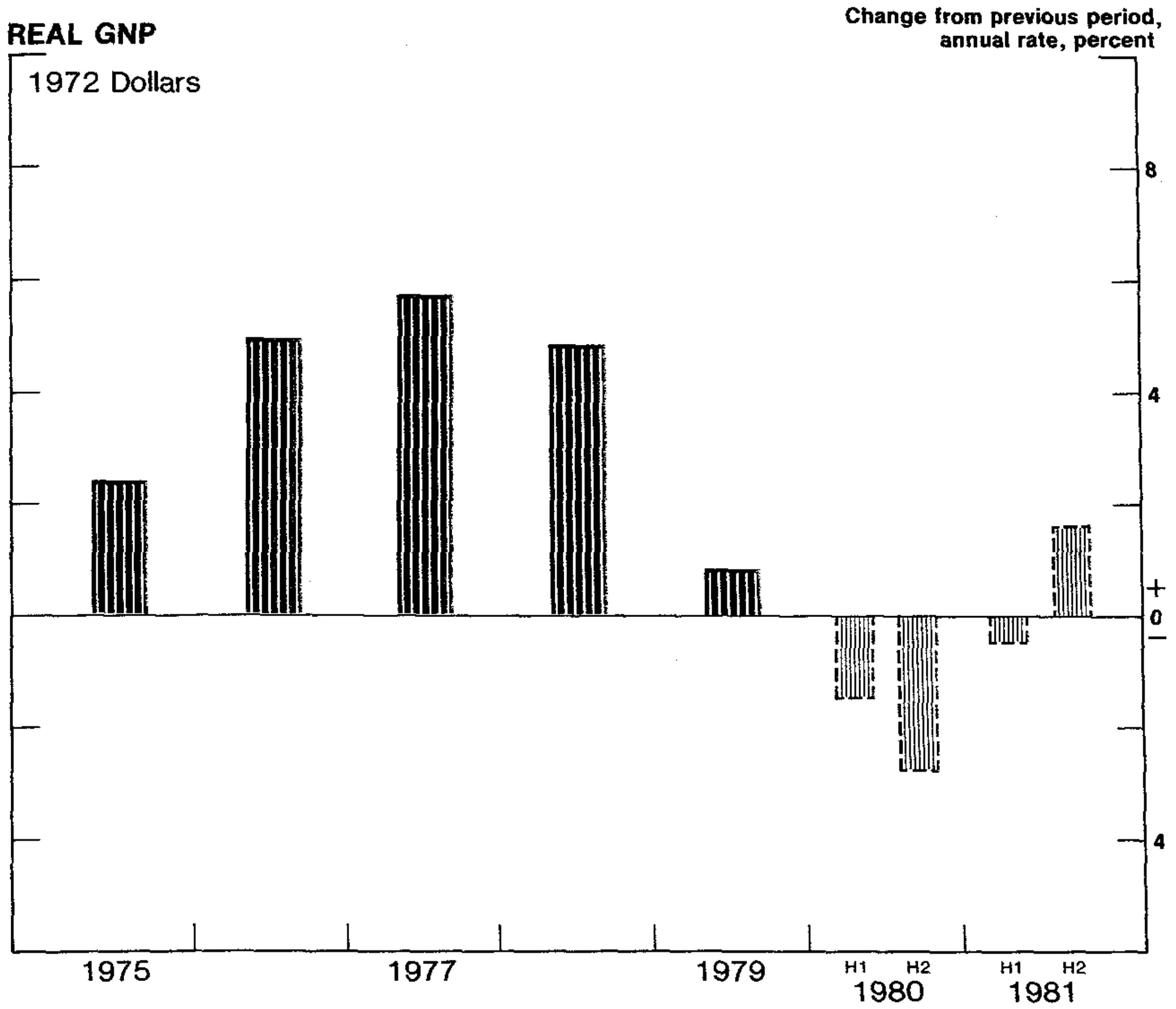


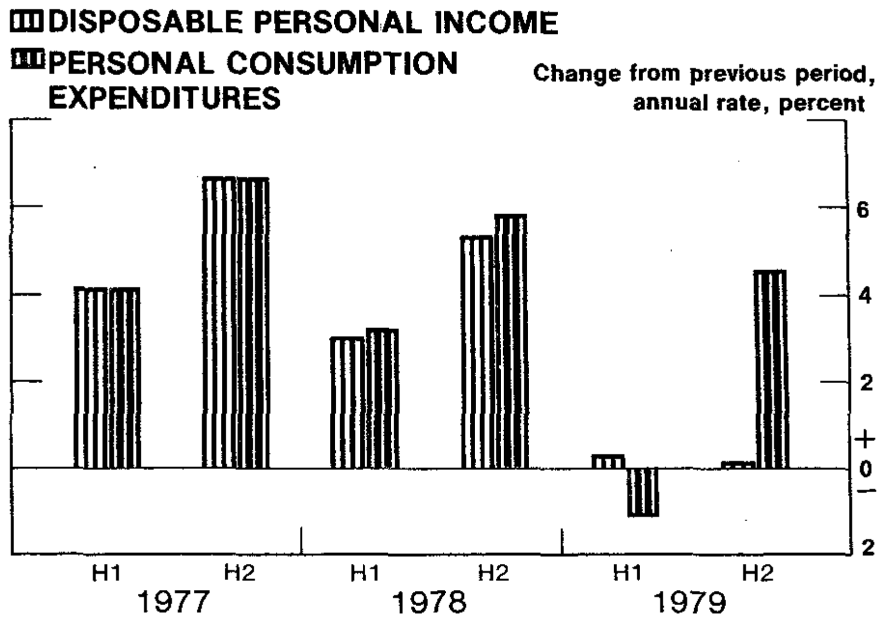
RETAIL SALES

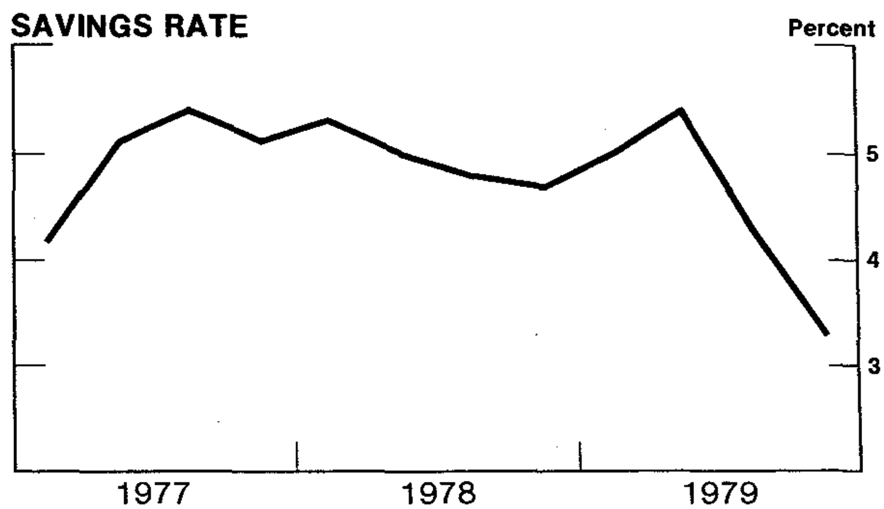


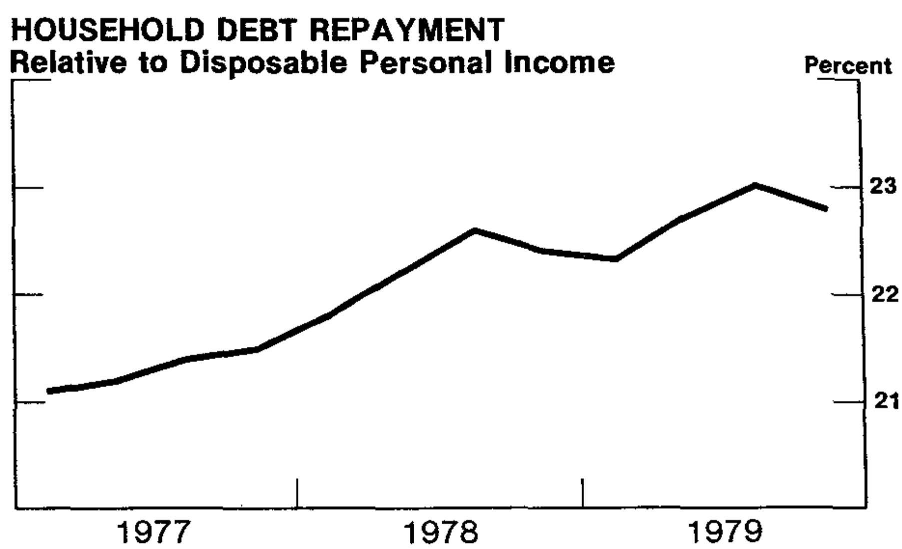
HOUSING STARTS

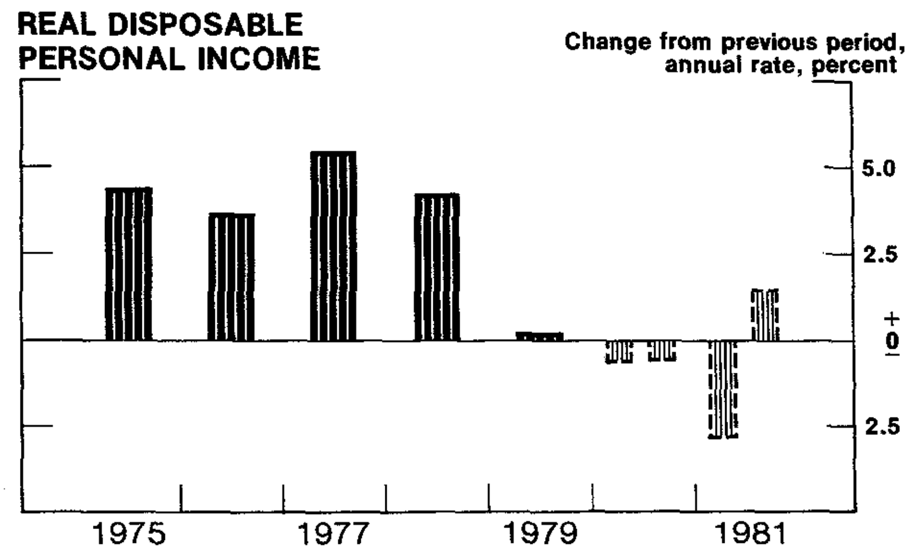


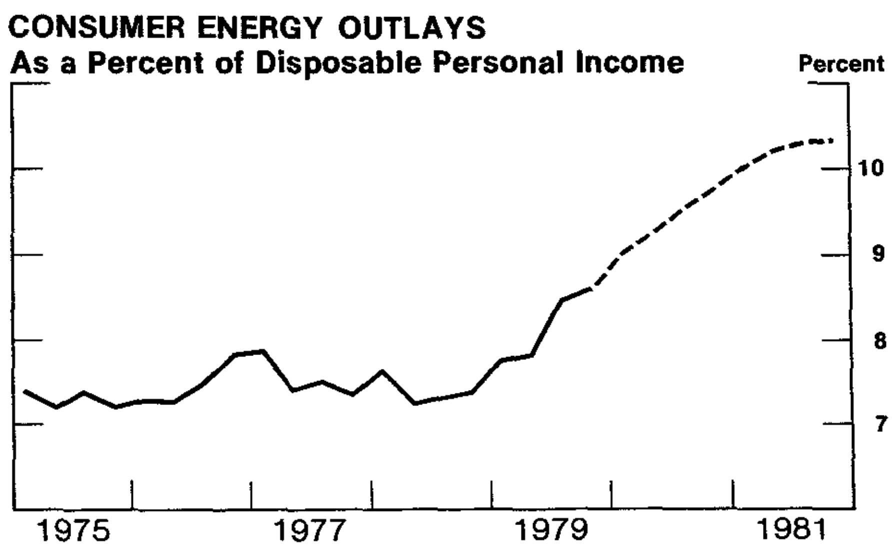

REAL GNP
Change from previous period, annual rate, percent
1972 Dollars
8
4
+
0
−
4
1975
1977
1979
H1
H2
1980
H1
H2
1981

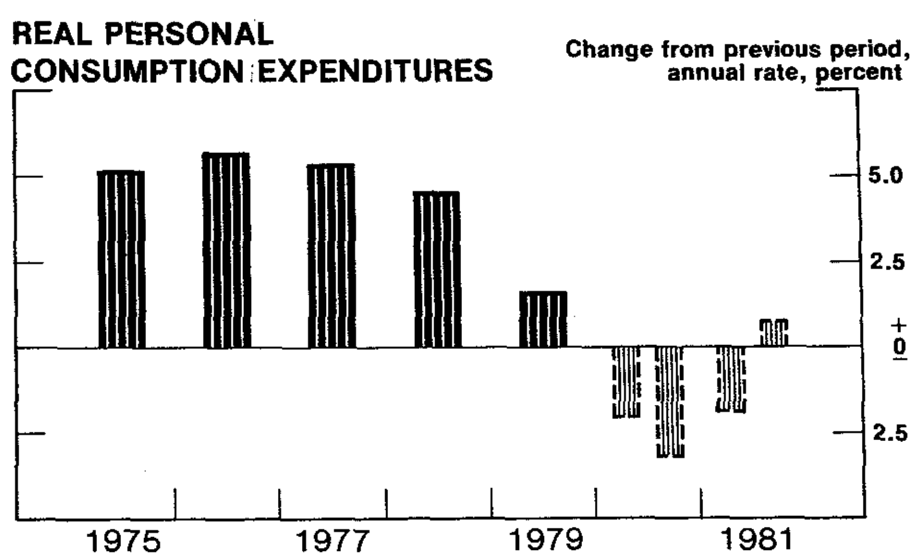

DISPOSABLE PERSONAL INCOME
PERSONAL CONSUMPTION EXPENDITURES
Change from previous period, annual rate, percent
6
4
2
+
0
−
2
H1
H2
H1
H2
H1
H2
1977
1978
1979


SAVINGS RATE
Percent
5
4
3
1977
1978
1979

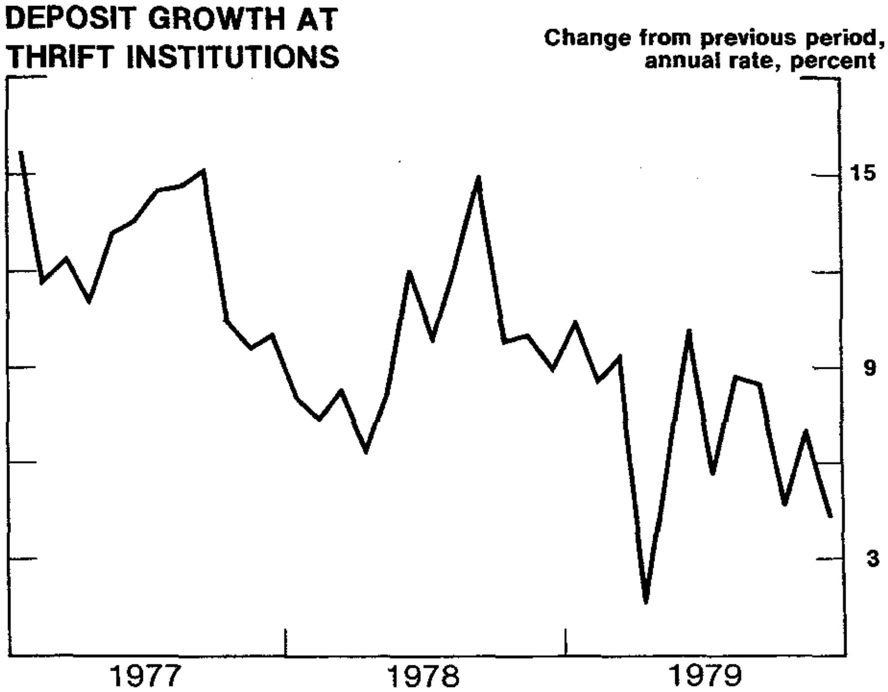

HOUSEHOLD DEBT REPAYMENT
Relative to Disposable Personal Income
Percent
23
22
21
1977
1978
1979


REAL DISPOSABLE PERSONAL INCOME
Change from previous period, annual rate, percent
5.0
2.5
+
0
-
2.5
1975
1977
1979
1981

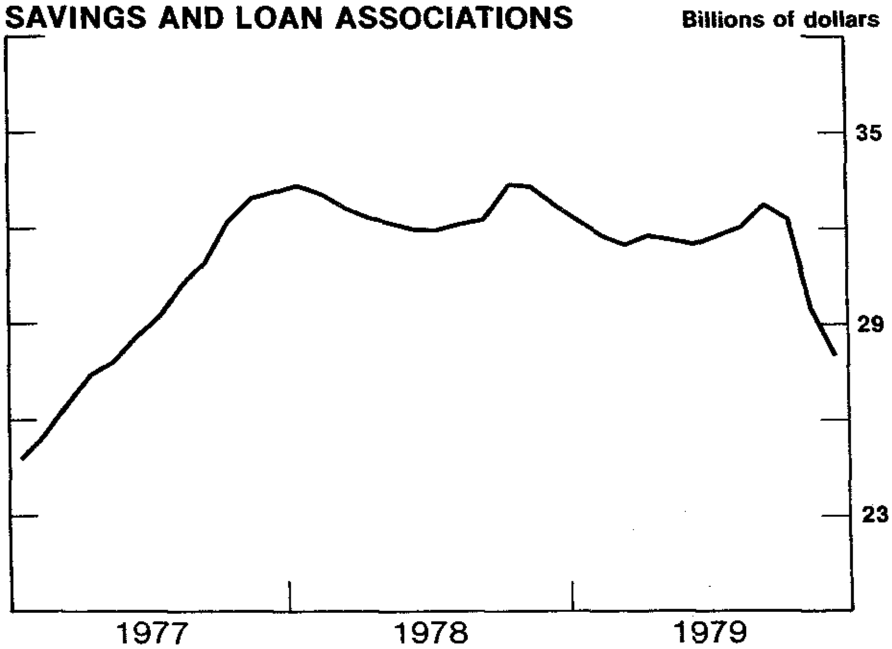

CONSUMER ENERGY OUTLAYS
As a Percent of Disposable Personal Income
Percent
10
9
8
7
1975
1977
1979
1981


REAL PERSONAL CONSUMPTION EXPENDITURES
Change from previous period, annual rate, percent
5.0
2.5
+
0
-
2.5
1975
1977
1979
1981

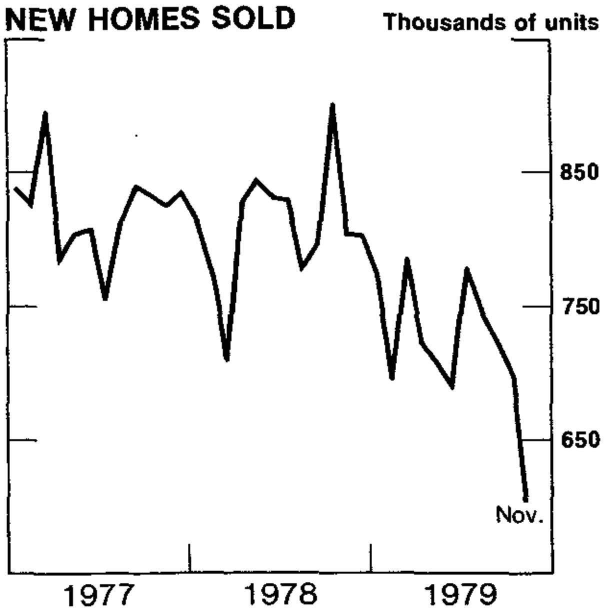
DEPOSIT GROWTH AT THRIFT INSTITUTIONS



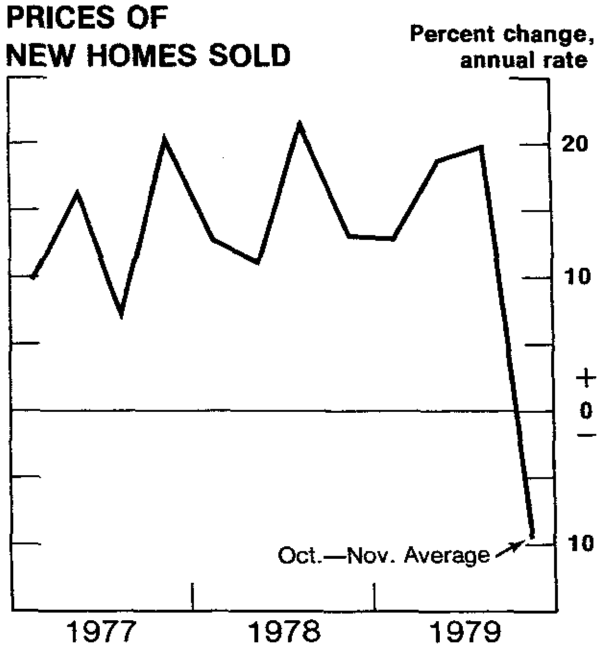
OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS



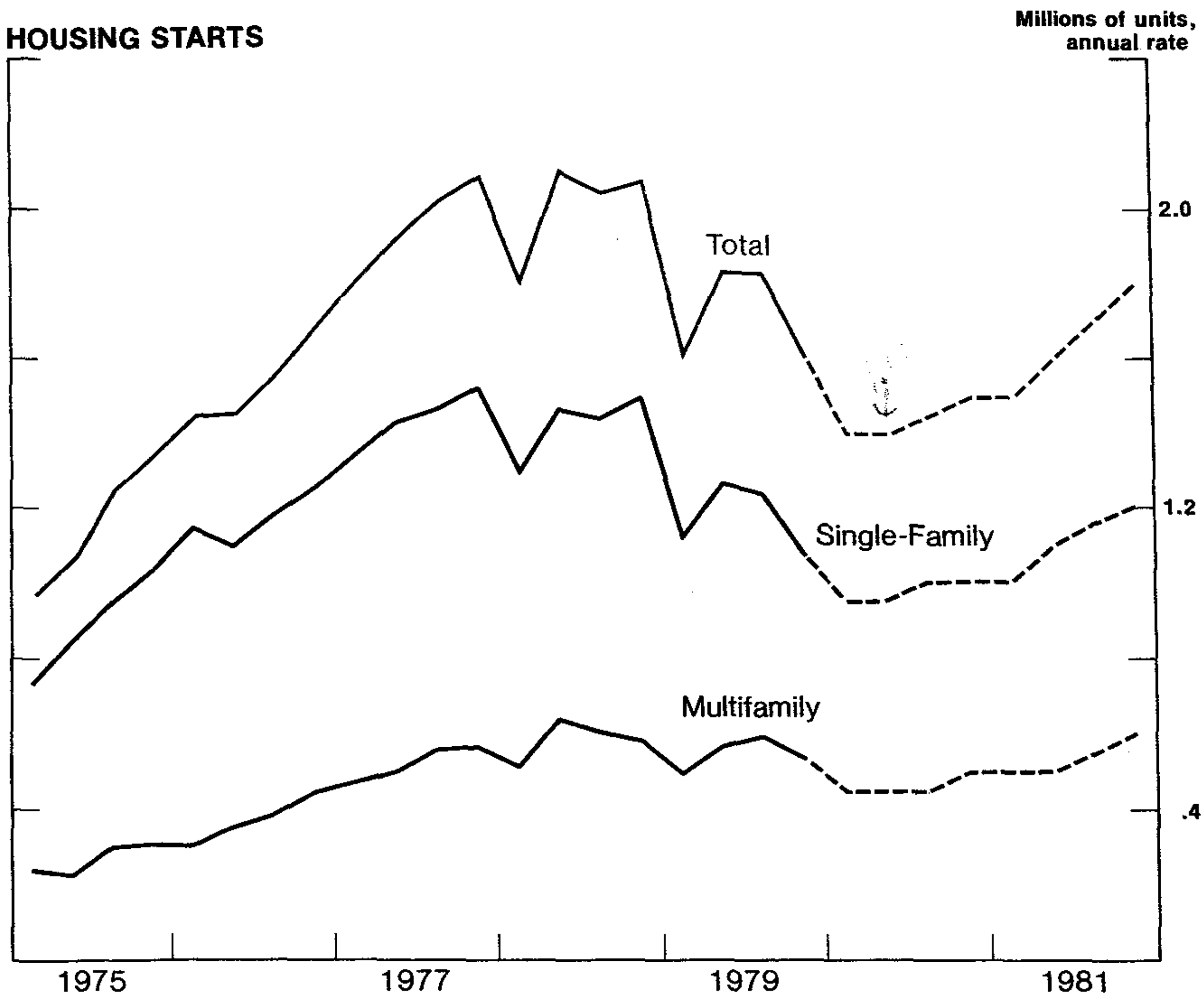
NEW HOMES SOLD

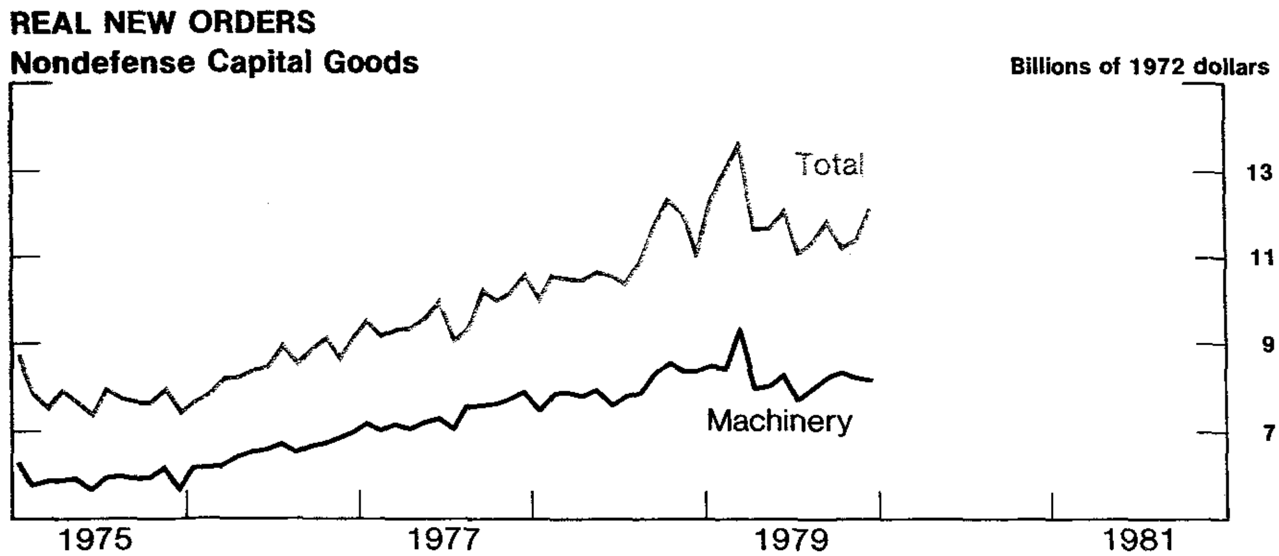


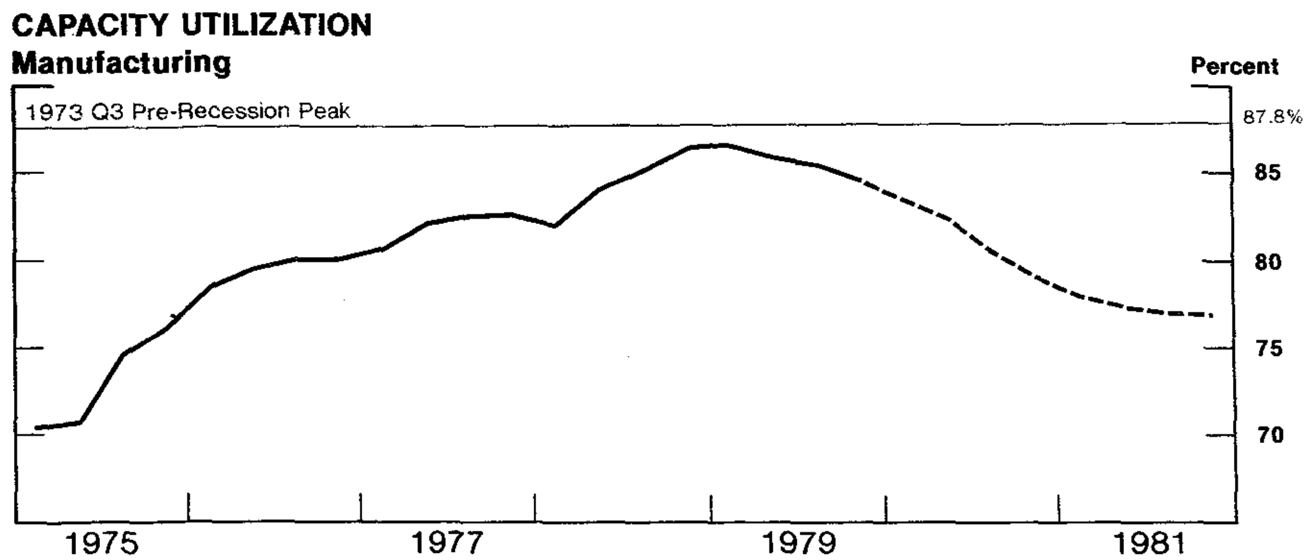
PRICES OF NEW HOMES SOLD

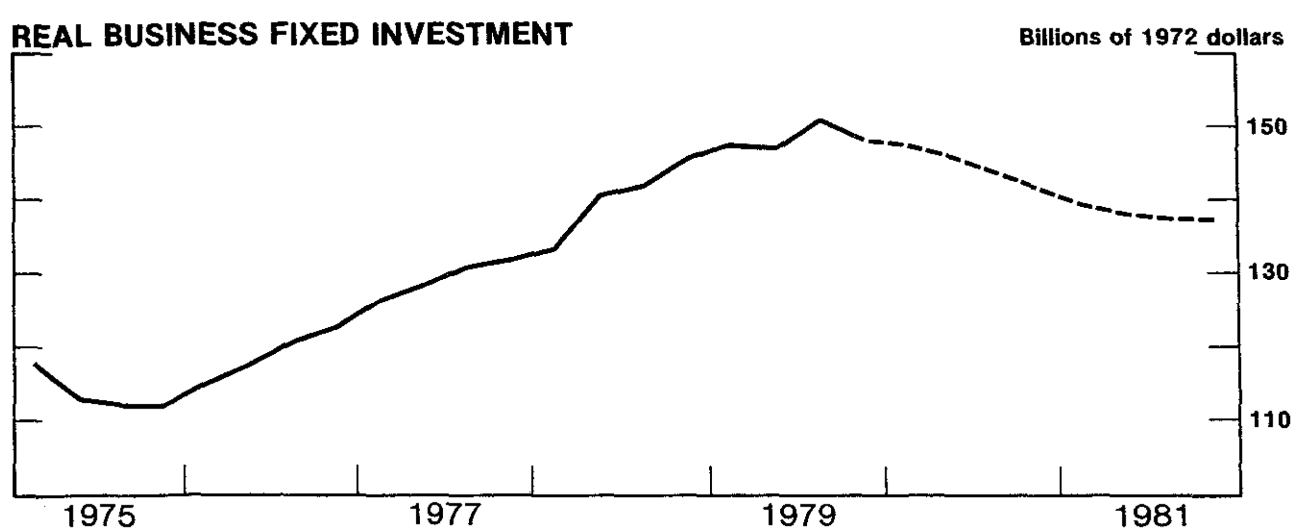


HOUSING STARTS

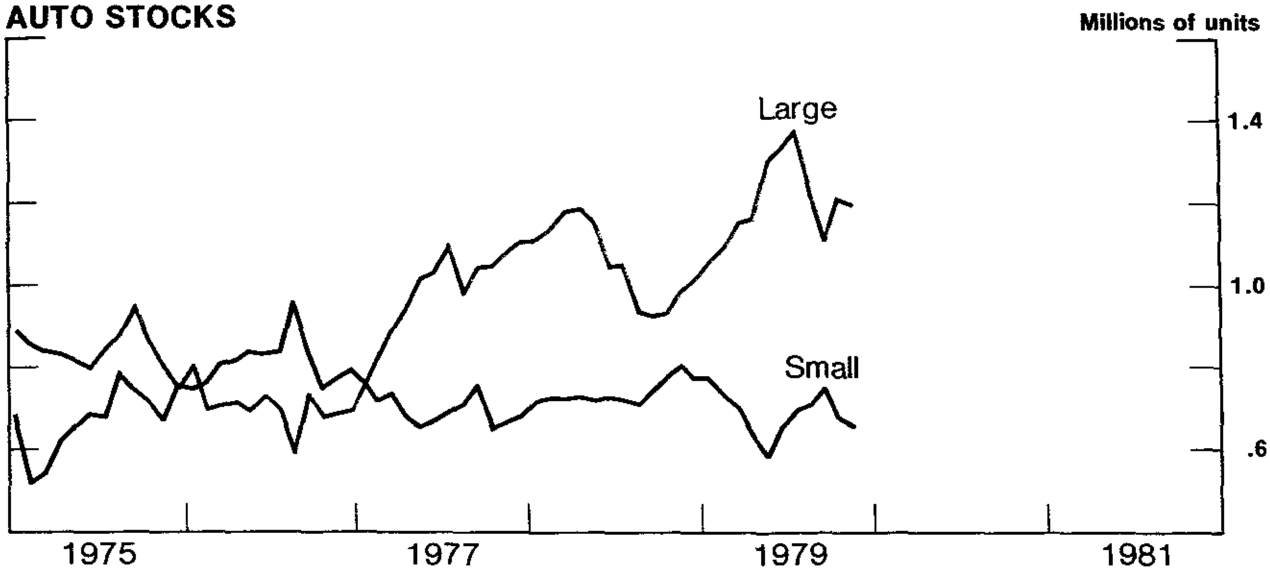



REAL NEW ORDERS
Nondefense Capital Goods
Billions of 1972 dollars
Total
Machinery
13
11
9
7
1975
1977
1979
1981

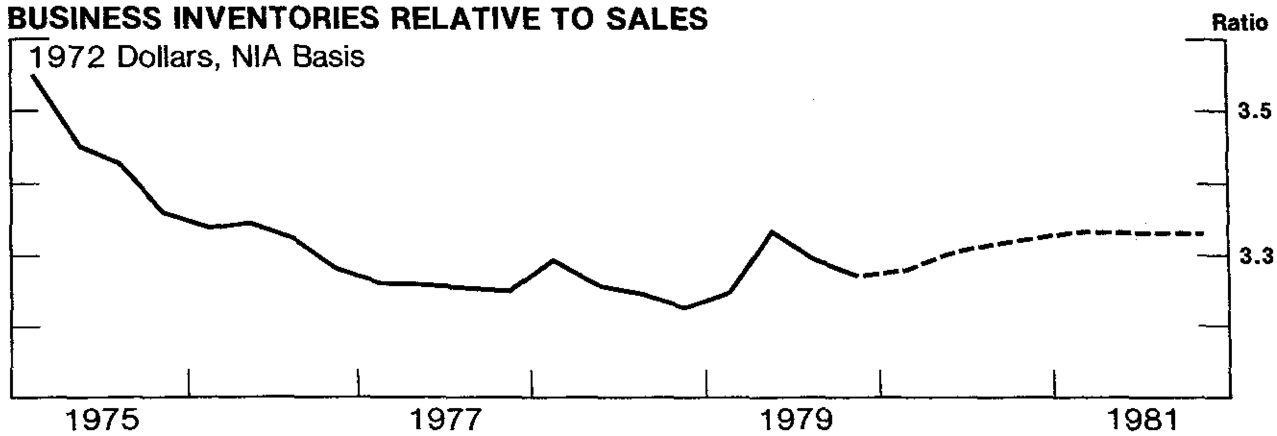

CAPACITY UTILIZATION
Manufacturing
Percent
1973 Q3 Pre-Recession Peak
87.8%
85
80
75
70
1975
1977
1979
1981


REAL BUSINESS FIXED INVESTMENT
Billions of 1972 dollars
150
130
110
1975
1977
1979
1981

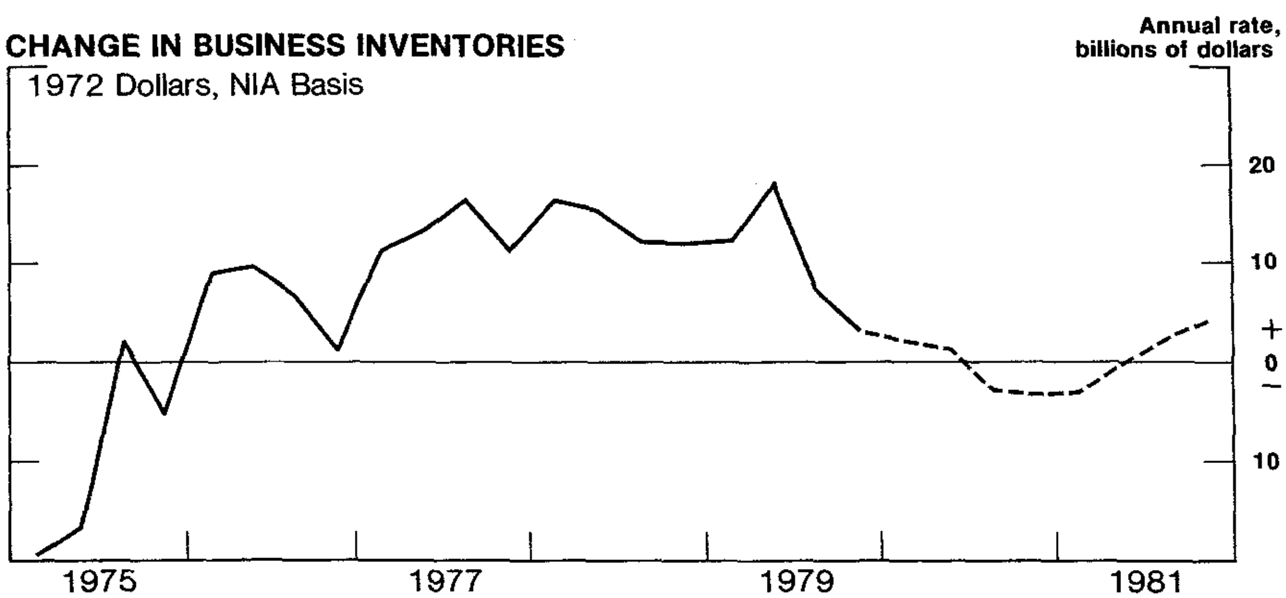
AUTO STOCKS



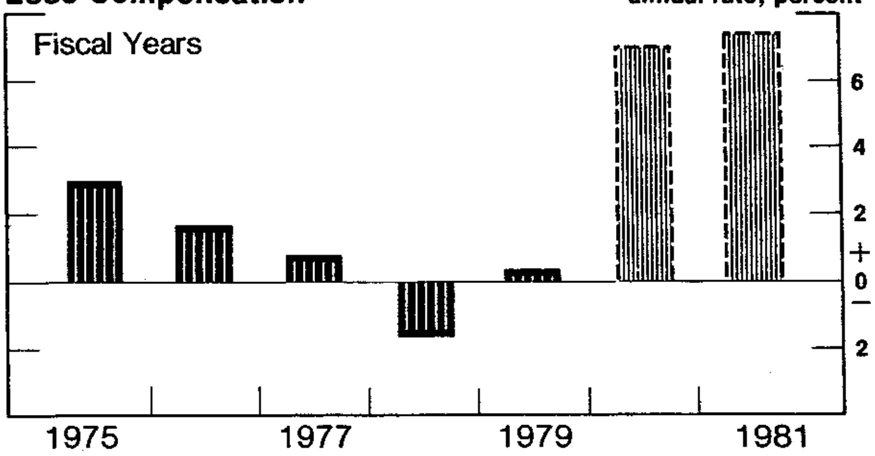
BUSINESS INVENTORIES RELATIVE TO SALES



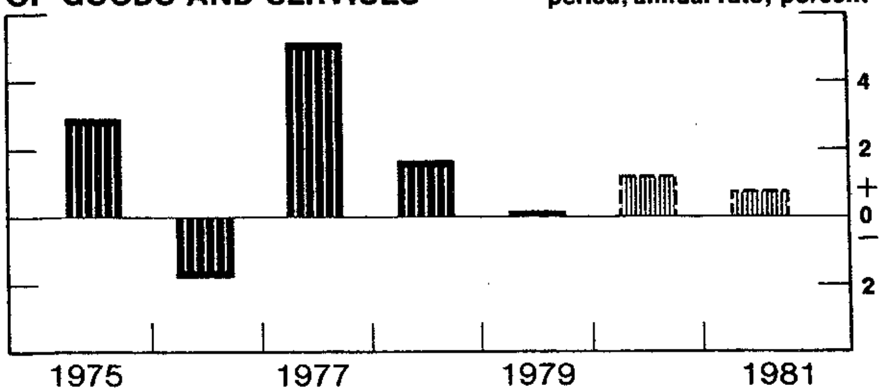
CHANGE IN BUSINESS INVENTORIES



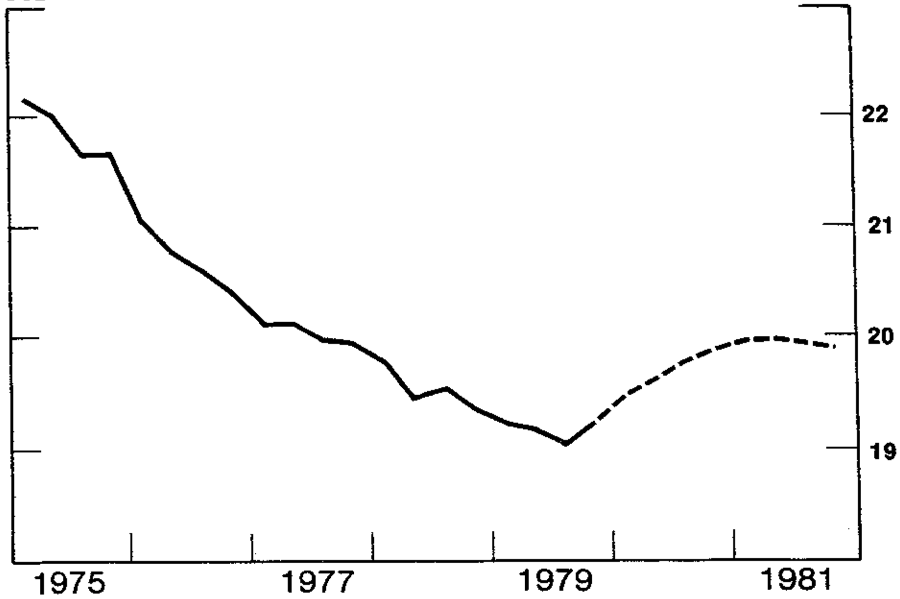
REAL DEFENSE SPENDING
Less Compensation



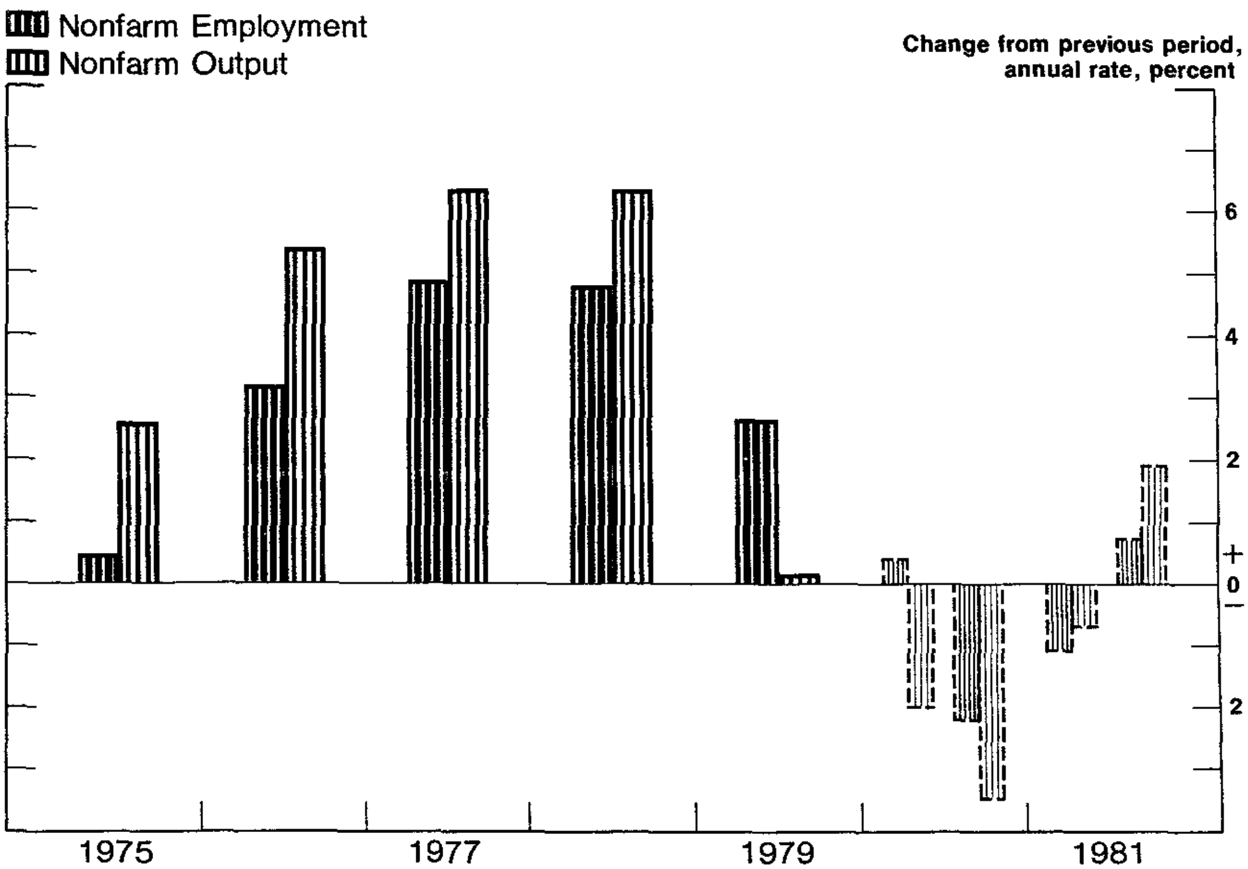
REAL GOVERNMENT* PURCHASES OF GOODS AND SERVICES



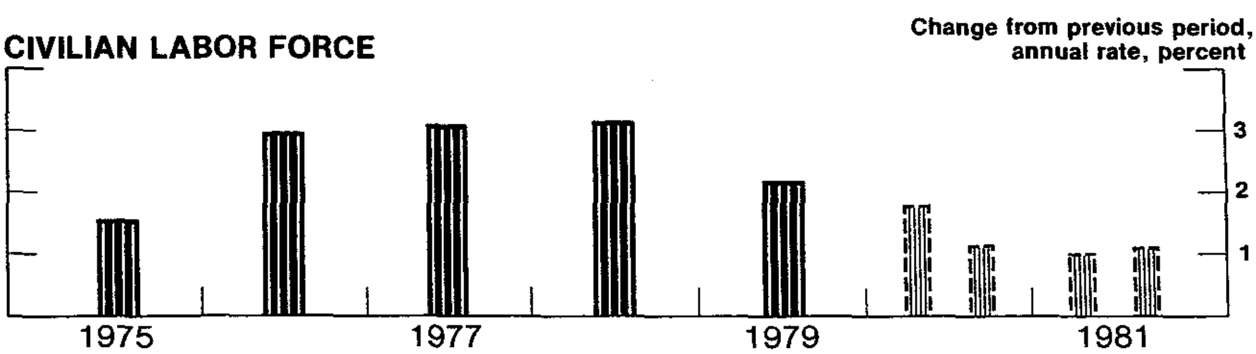
REAL GOVERNMENT* PURCHASES AS A SHARE OF GNP



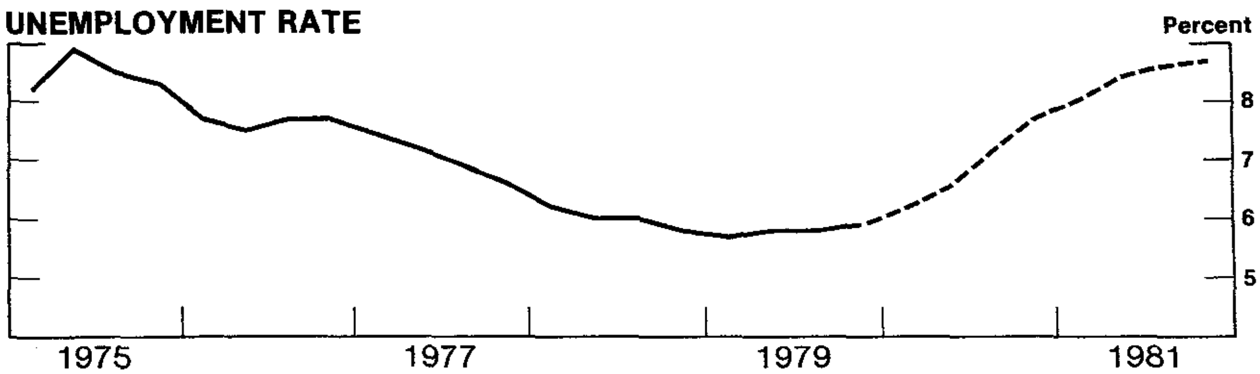
*Federal and State and local



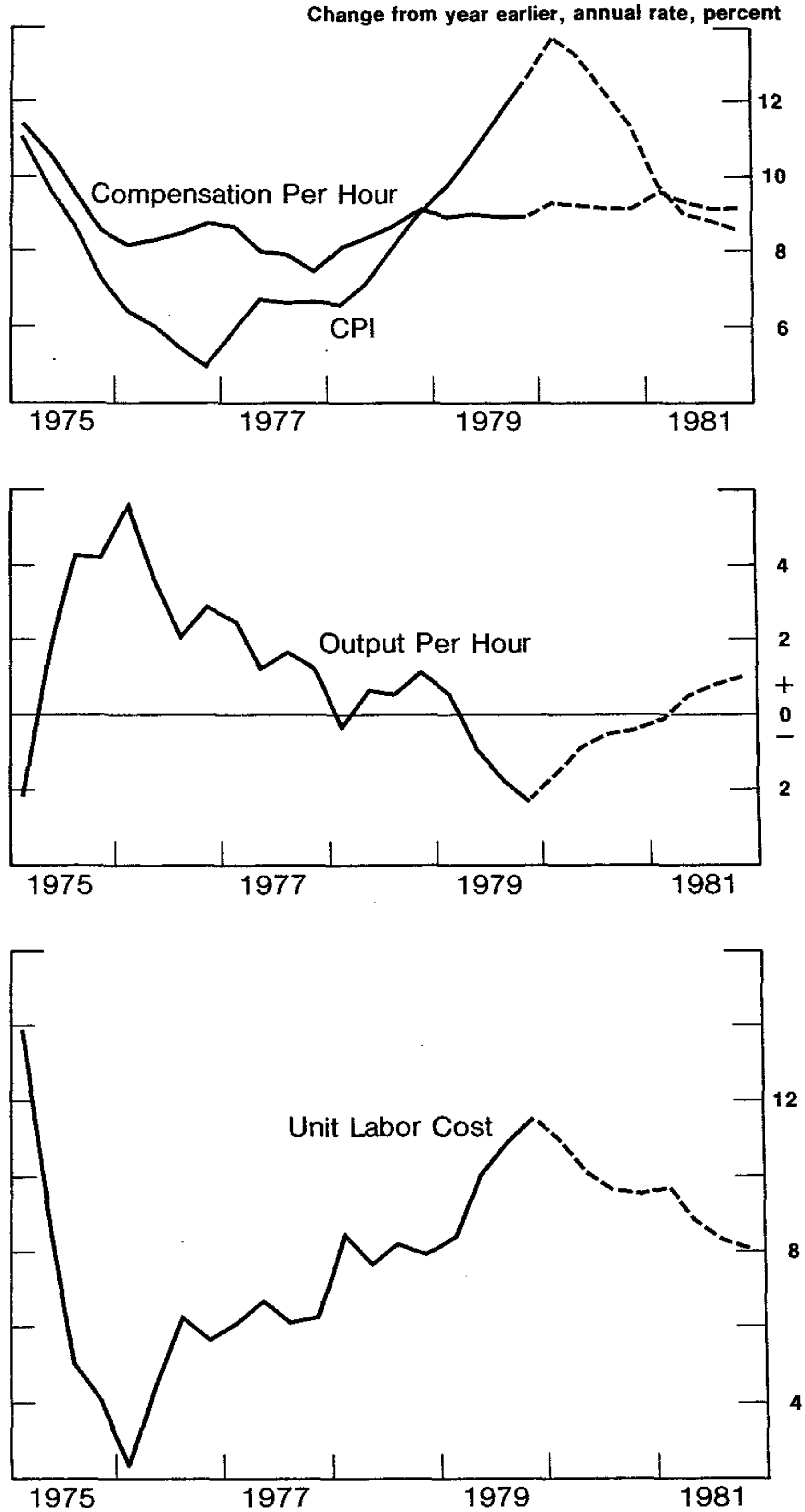
CIVILIAN LABOR FORCE



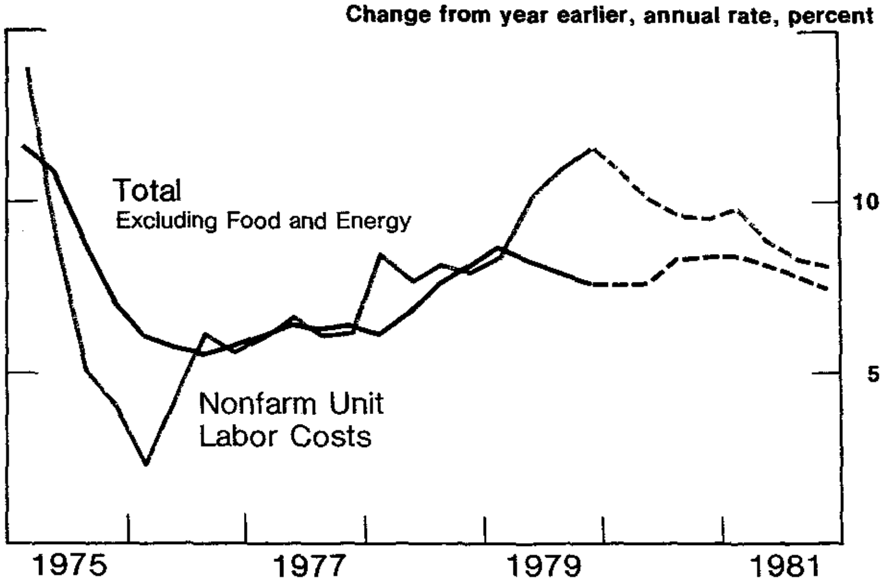
UNEMPLOYMENT RATE

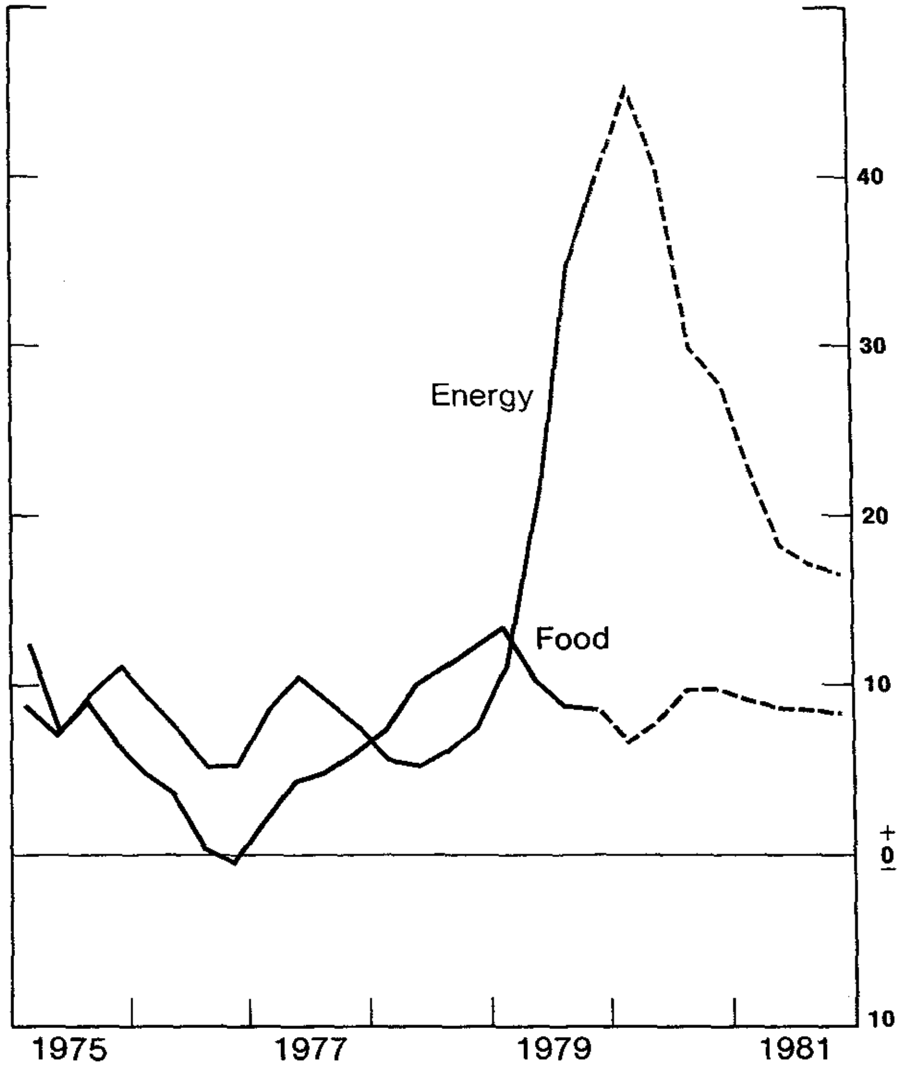


UNIT COST INDICATORS
Nonfarm Business Sector

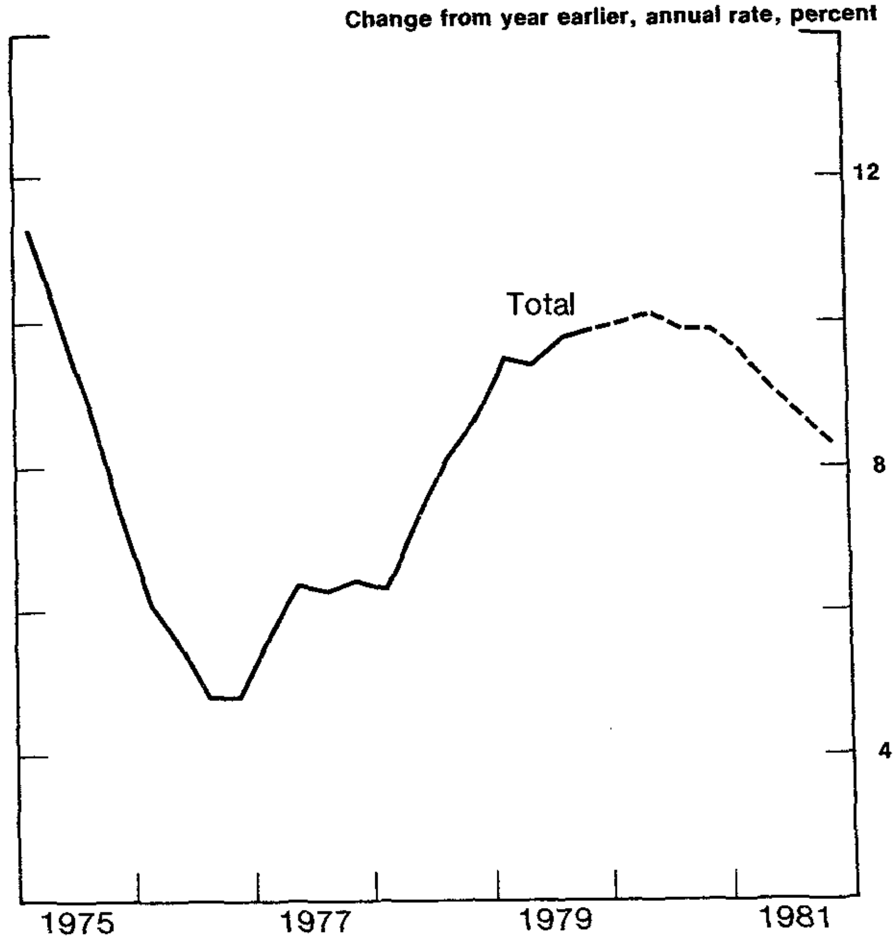


PRICES
Gross Domestic Business Product

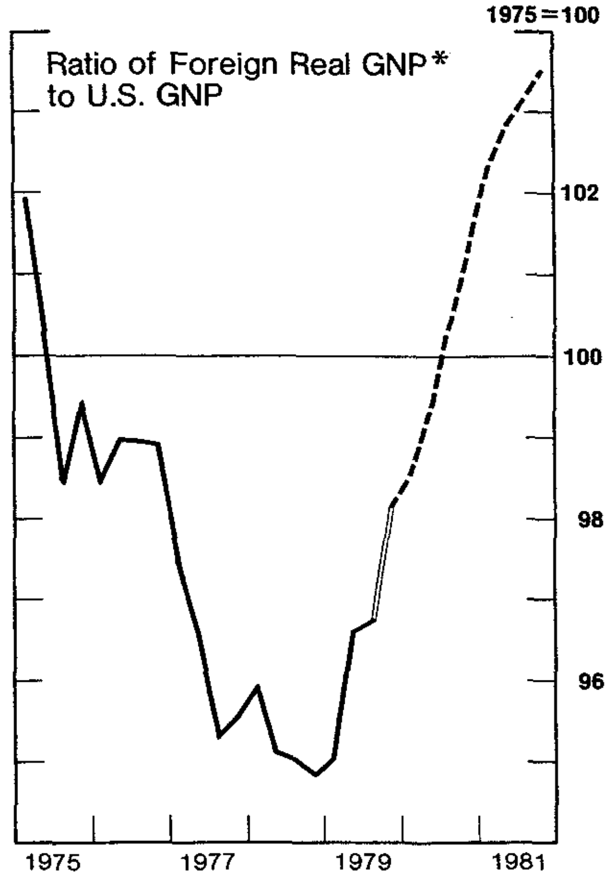




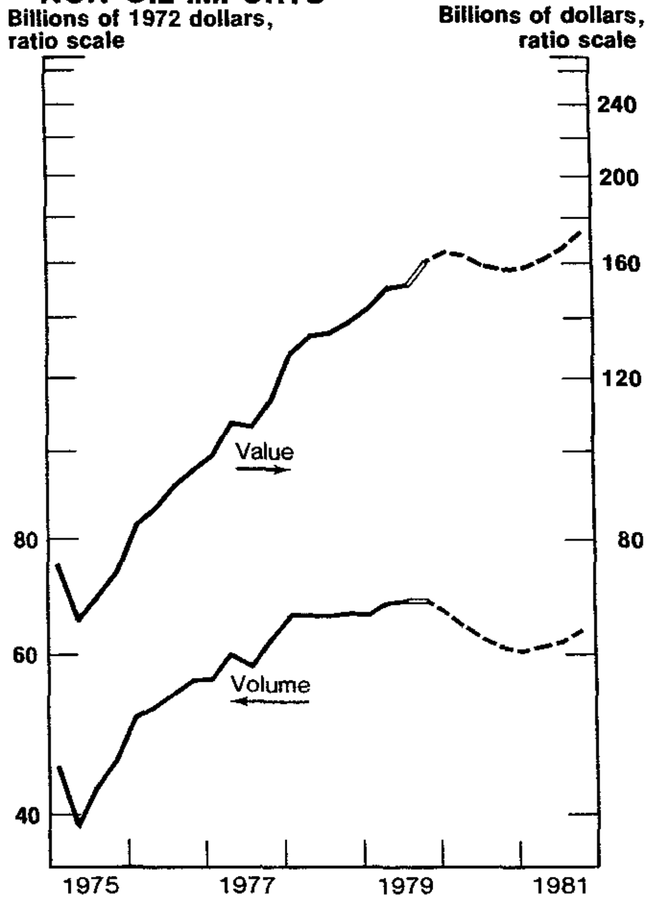
PRICES
Gross Domestic Business Product



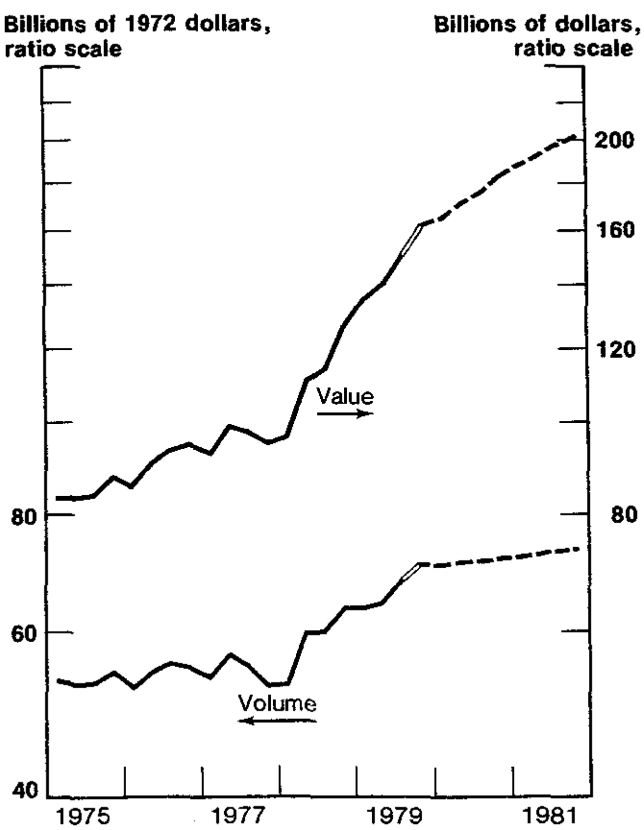
ACTIVITY RATIO



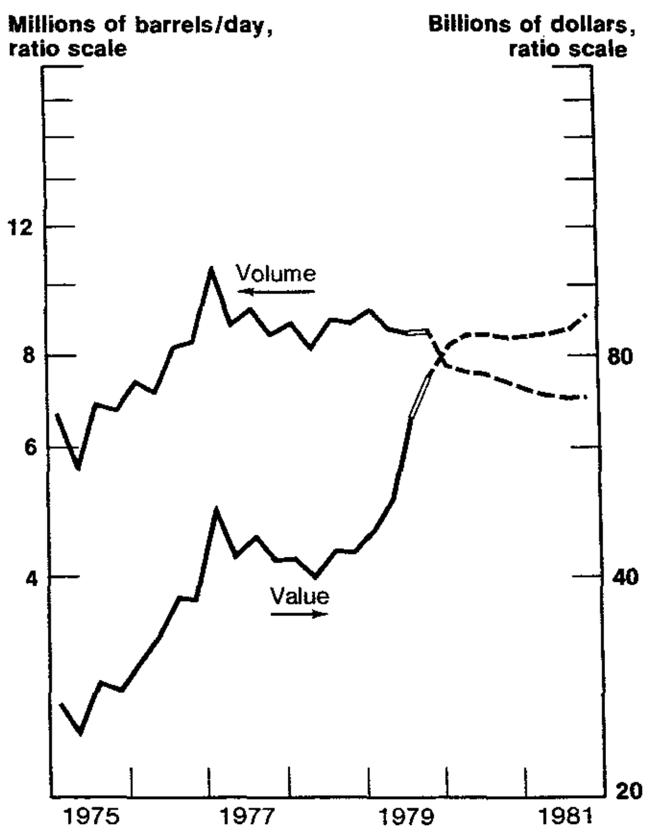
NON-OIL IMPORTS



NONAGRICULTURAL EXPORTS

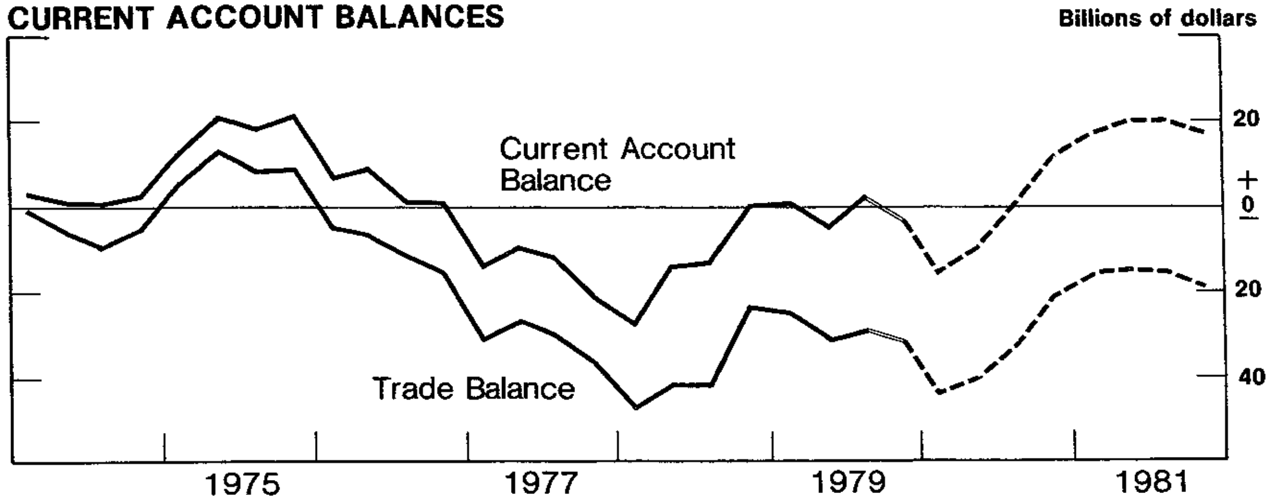


OIL IMPORTS

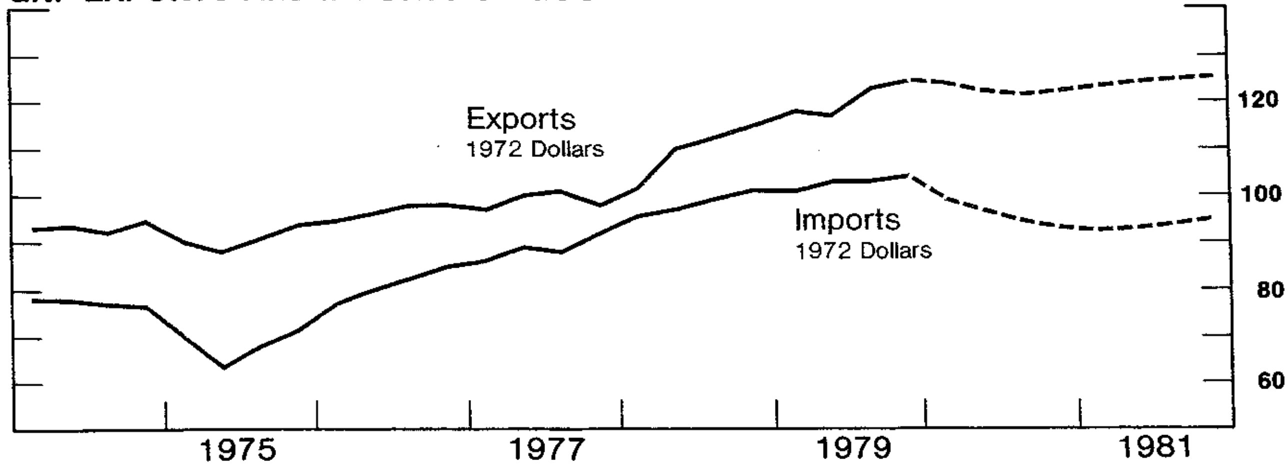


* Weighted average against G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

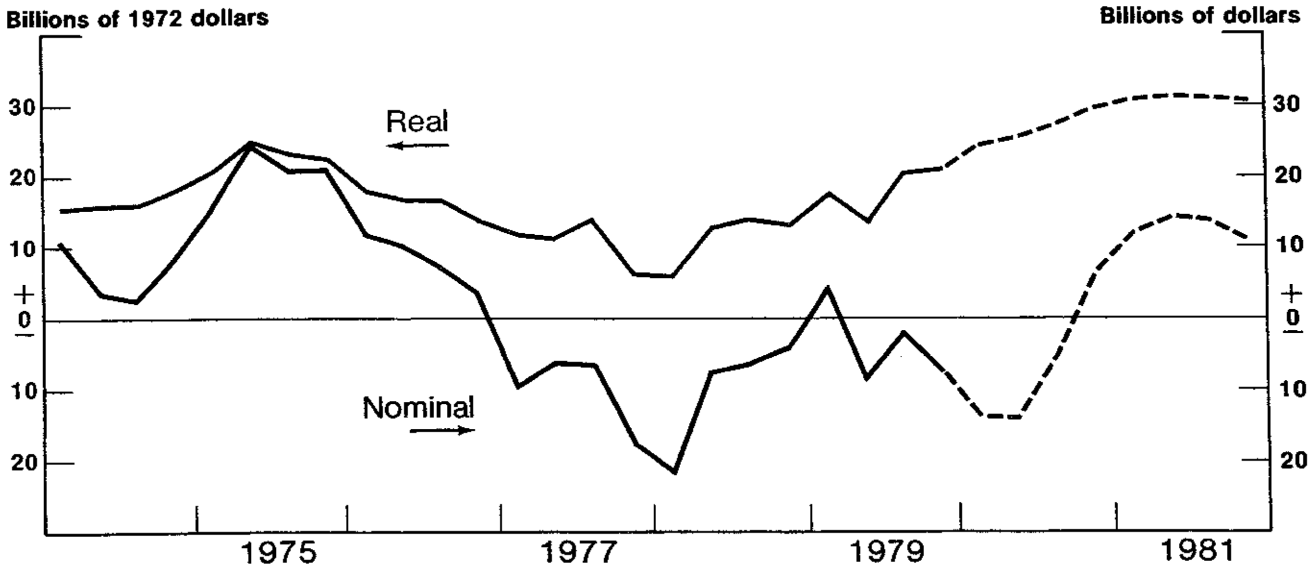
MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES



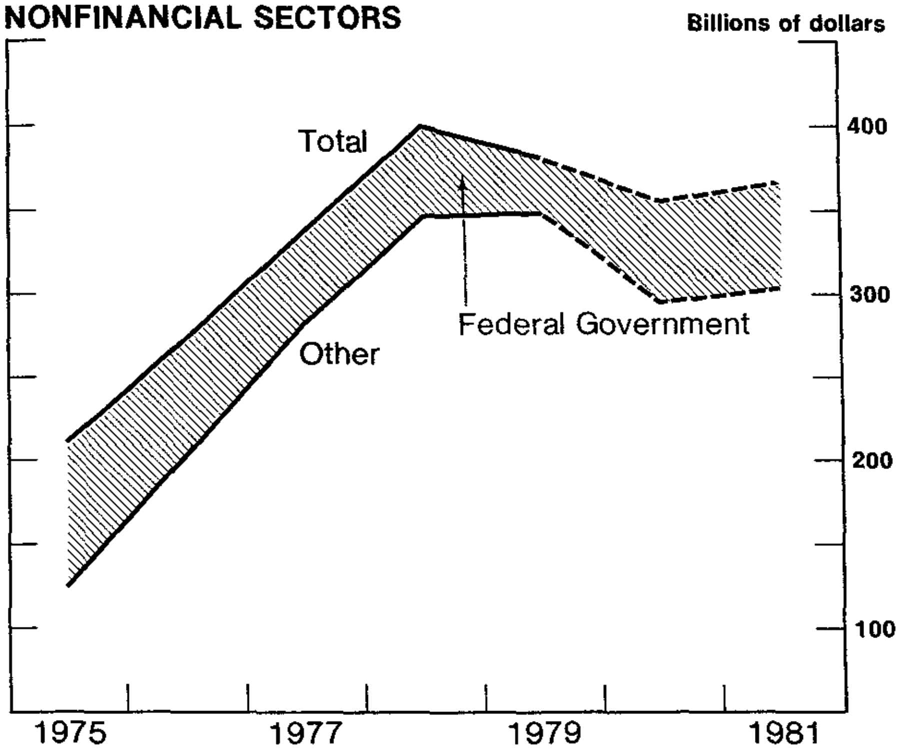
GNP EXPORTS AND IMPORTS OF GOODS AND SERVICES



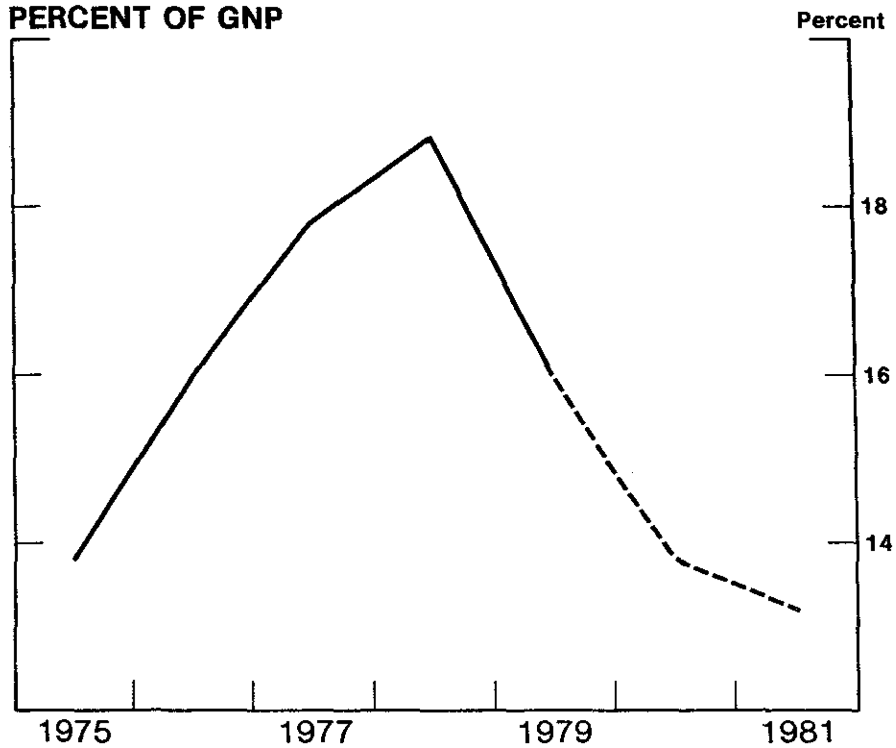
GNP NET EXPORTS



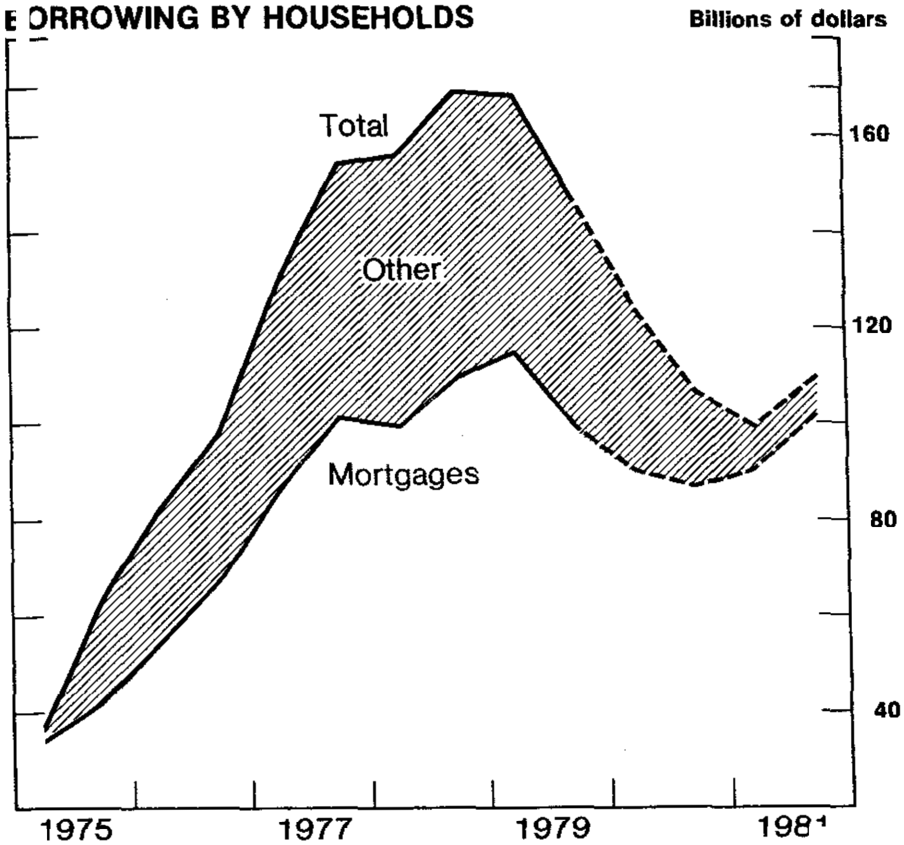
FUNDS RAISED BY NONFINANCIAL SECTORS



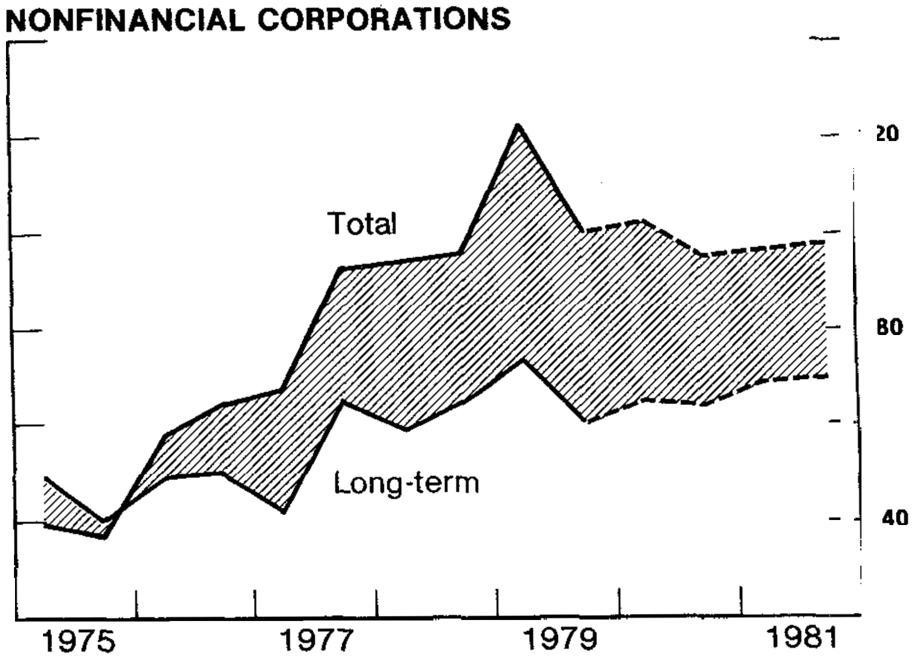
FUNDS RAISED AS A PERCENT OF GNP



BORROWING BY HOUSEHOLDS



BORROWING BY NONFINANCIAL CORPORATIONS



FOMC Briefing
SHA: 2/5/80

Thus far--and in large part thanks to the miracle of major seasonal and definitional revisions in the money supply--money growth, measured by narrow definitions, appears on track with the target for December to March set by the Committee at its last meeting. But such a course now looks as if it will be associated with less ease in credit conditions than might have been expected at that time. Money demands are likely to be stronger in reflection of a revised and less weak staff GNP projection for the first quarter. As a result, should that projection be accurate, the quite moderate increase in money supply targeted by the Committee may entail little, if any, decline in the Federal funds rate over the weeks immediately ahead. But, with economic activity projected to be weaker in the second quarter, some further decline in the funds rate is more likely to occur in early spring, particularly if the Committee were to encourage a bit more rapid expansion in M-1A or M-1B in the second quarter than in the first, as suggested by alternative B.

But there may also be some question about whether it will in fact be possible to keep money growth to modest proportions over the coming months without exerting upward pressure on the funds rate. Such upward pressure would be most likely to arise, of course, if the economy strengthens relative to the staff forecast. In that case upward rate pressure would appear consistent with the cyclical situation.

On the other hand, there are two possible developments that could tend to lead to the seeming anomaly of upward short-term interest rate pressures in a weakening economy, given money growth over the next few months along the alternative B path. One would be emergence of greater demand for money relative to income than the staff is projecting. We have assumed that money demand will be weak enough to permit a bit stronger behavior in velocity of M-1A and M-1B over this and the next quarter than has usually been the case in post-war cyclical peak-to-trough periods. In the present inflationary environment the public in fact may be content to let the real value of cash balances decline sharply and attempt to maintain the real value of wealth--to the extent they can--by, say, acquiring other physical and financial assets that are more hedged against price rises. But if the public should turn out not to be willing to let cash balances decline relative to income, interest rates would come under upward pressure and/or nominal GNP under downward pressure as the public adjusts to the constrained supply of money.

The second development that could generate upward rate pressures over the next few months has somewhat greater odds of occurring. This would be the impact on money growth of the considerable bulge, relative to earlier years, in individual income tax refunds that is expected to begin sometime in late winter. While we are reasonably confident about our estimate of the amount of these refunds, we are quite uncertain about the exact timing--which depends on the speed with which the public files tax forms and the speed with which the IRS processes them. We are also uncertain about the exact response of the public to refunds received--whether placed initially in demand accounts or immediately in other assets, and if in demand accounts, whether they stay only one day or more. As noted in the bluebook, we would expect any upward impact of the refunds on money to be temporary--that is, it would not reflect a more permanent shift in money demand but would be followed in late spring and early summer by a tendency for money to grow slower.

Because of all the uncertainties involved no advance special allowance was made in the proposed monetary targets for the impact of tax refunds. Therefore, if the refunds do in fact tend to raise growth in the monetary aggregates beyond the proposed targets, short-term interest rates would temporarily come under upward pressure--a pressure that would be reversed later in the spring and summer as the flow were in effect reversed. However, the Committee may not wish to see interest rates rising over the months ahead for such a reason, especially if in fact the economy is weakening.

So far as I can see there is no easy practical solution to the dilemma posed by tax refunds. Deciding to adjust reserve paths to permit more money growth to the extent such growth can be identified as related to tax rebates has an appeal, but it is difficult to be certain that a higher money growth in any month is in fact temporary and related to the rebates. We have had experience in the past under a funds rate target--a target that makes it easy to accommodate to temporary bulges in money growth--where the bulge in growth has not been reversed, or fully reversed, and money over time ran higher than desired. Moreover, in deciding on whether to make any special allowance the Committee would probably also want to take account of the public impact of upward adjustments in targets--even by no more than the 1 or 2 percentage points that we now estimate to be the special effect of tax refunds--at a time when many in the market have been questioning the resolve of policy, though doing so for misguided reasons.

One approach would be to ignore the question on the ground that impacts on money now seem relatively minor, or it might be ignored on the ground that the risk of permitting higher growth in money can't be taken in the present environment. On the other hand, if the Committee wished to allow for some temporary increase in money growth, it might do so by recognizing--either in the directive or in the policy record--the possibility that money growth might deviate temporarily from target in case of unusually large individual income tax refunds.

If the Committee desired to make such an allowance, there are a number of ways to do so. One way would be to indicate that the Manager need not lower the nonborrowed reserve path over the next few months if total reserves are running persistently strong. In that case, interest rates would probably rise as borrowing rose but not by as much as if nonborrowed reserves were lowered. A much more accommodative approach would be to raise the nonborrowed reserve path to the extent that any bulge in money appeared to reflect the rebates, as determined by, say, analysis of the actual bulge in money compared with the actual timing of rebates. But such an interpretation leaves the staff with a very difficult and ticklish analytic problem. A third less rigid interpretation would be to permit the Manager to be tolerant of a little more money growth than formally targeted should that emerge, and there was reason to think it was related to refunds, without straining for precision in hitting total and nonborrowed reserves targets.

A final, brief word Mr. Chairman on another practical problem--the problem of which of the proposed aggregates should be given most weight in adjustments, if any, to the reserve path. On that issue, at present, I would suggest roughly equal weight to M-1A and M-1B, so as to minimize the risk that we are not overlooking significant growth in transactions balances. In any event, as a practical matter, M-1A and M-1B ought to move closely together under current circumstances. I would suggest giving M-2 a more subsidiary role until we have more experience with it and with assessing the significance for policy of changing behavior of money market funds and overnight RP's relative to uncertain staff projections.